Study Group on European Cooperative Law (SGECOL)
Principles of European Cooperative Law (PECOL)

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UK National Report on PECOL chapter 3
"Cooperative Finance"

(October 2013)

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LIST OF ABBREVIATIONS

Bencom = IPS registered to conduct business for the benefit of the community
CA 2006 = Companies Act 2006
C(AICE)A 2004 = Companies (Audit Inspection and Community Enterprise) Act 2004
CIC = Community Interest Company.
CLG = Company Limited by Guarantee
FCA = Financial Conduct Authority
GM = General Meeting
IFRS = International Financial Reporting Standards
IA 1986 = Insolvency Act 1986
IM = Investor/Non-user Member
IPS = Industrial and Provident IPS
IPSA = Industrial and Provident Acts 1965-2003
LLP = Limited Liability Partnership
LLPA = Limited Liability Partnerships Act 2000
Ltd. = Private Limited Company
PA = Partnership Act 1890
PLC = Public Limited Company
SCE = European Cooperative IPS
WSC = Withdrawable Share Capital

1. The Legal Context of Cooperative Financial Structure

1.1. Cooperative Financial Structure and Cooperative Identity.

As noted in the UK reports for PECOL Chapters 1 (identity) and 2 (governance), for IPSs registered under IPSA, identity is mainly dealt with by the administrative discretion of the FCA as registrar rather than by detailed legislative provision. The FCA seeks to ensure that each IPS meets, and continues to meet, the condition of registration either that it is a "bona fide co-operative" or that its business is being, or is intended to be," run for the "benefit of the community" - section 1(2) of IPSA 1965.

The only specific statutory provision about the definitions is that a IPS that carries on business with the object of making profits mainly for the payment of interest, dividends or bonuses on money lent to, invested in, or deposited with, the IPS does not qualify as a bona fide co-operative – section 1(3) IPSA 1965. This is relevant to the capital structure and surplus distribution rules governing IPS's.

For co-operatives set up using a business structure other than such a IPS, similar criteria will be applied to decide whether it may use the word "co-operative" as part of its registered name or business name - sections 55(1) & 1194(1) CA 2006 and SI 2009/2615 schedule 1.

The link between the ICA Principles and other international indications of how co-operative capital should be organised is to be found in the FCA's Guidance on the Registration of IPS's.

Mutual Co-operatives

The FCA Notes provide as follows for IPS's registered as bona fide co-operatives:

> "Interest on share and loan capital - Where part of the business capital is the common property of the co-operative, members should receive only limited compensation (if any) on any share or loan capital which they subscribe. Interest on share and loan capital must not be more than a rate necessary to obtain and retain enough capital to run the business. Section 1(3) of the 1965 Act states that a society may not be a bona fide co-operative if it carries on business with the object of making profits mainly for paying interest, dividends or bonuses on money invested with or lent to it, or to any other person.

> Profits - If the rules of the society allow profits to be distributed, they must be distributed among the members in line with those rules. Each member should receive an amount that reflects the extent to which they have traded with the society or taken part in its business. For example, in a retail trading society or an agricultural marketing society, profits might be distributed among members as a dividend or bonus on purchases from or sales to the society. In other societies (for example, social clubs) profits are not usually distributed among individual members but members benefit through cheaper prices or improvements in the amenities available."

General Interest Co-operatives

For IPS's registered as benefit of the community societies (which which may be general interest co-operatives in PECOL terms) the provisions on capital and surplus distribution are :

> "Interest on share and loan capital - It is unusual for a benefit of the community society to issue more than nominal share capital (for example, one £1 share per member). Where it does issue more than nominal share capital or where members make loans to the society, or both, any interest paid must not be more than a reasonable rate necessary to obtain and retain enough capital to run the business.
>
> Profits and assets – The society's rules must not allow either profits or the society's assets to be distributed to the members. Profits must generally be used to further the objects of the society by being ploughed back into the business. Where profits are used in part for another purpose, that purpose should be similar to the main object of the society, for example, for philanthropic or charitable purposes. The rules must specify the beneficiary or beneficiaries, if any.
>
> Where the rules of the society allow assets to be sold, the proceeds of the sale should be used to further the society's business activities only."

- FCA & PRA, Mutual IPS's Registration Form Notes downloaded from http://www.fca.org.uk/your-fca/documents/forms/registering-a-new-industrial-and-provident-IPS-notes on 29.09.2013 at page s 8-9.

In this report reference will be made to these provisions as necessary.

UK Registration Criteria and the PECOL Classification of Co-operatives: A Note

While the concepts of bona fide co-operative and bencom share some of the features of PECOL's division between mutual and general interest co-operatives, they are not identical. There is no requirement mentioned in the FCA Guidelines that a bencom must be controlled by its members and many are not subject to any meaningful democratic control, although some are. Similarly, the FCA assumes that a bencom will usually have no more than "nominal" share capital although more than that is permitted. Conversely, a bona fide co-operative may choose never to distribute any surplus and have purely nominal amounts of share capital e.g. £1 per member as a condition of membership rather than a source of funds for its business. There is no explicit condition about the proportion of business that a bona fide co-operative must conduct with its own members.

The CIC company structure allows for the dedication of assets to a general interest purpose – ss 26-63 C(AICE)A 2004. If other company structures are used it is possible to entrench the statutes to prevent change but amendment by unanimous agreement of the company's members is always possible – s 22(1) & (3) CA 2006

1.2. Financial Structure of the Cooperative and National Law on Business Organisation.

The financial structure of co-operatives is a matter largely left to the choice of each IPS or company through its own statutes[1] subject to certain specific legislative and judge-made legal rules. This reflects the liberal approach of UK business organisation law as discussed in the UK reports on both identity and governance. For co-operatives wishing to register as IPS's or to use the word "co-operative" the name of a business using a different legal structure, the FCA guidance referred to above is the main restriction on their freedom to decide matters in their own statutes.

A feature which encourages many co-operatives to use the IPS structure is the availability of "withdrawable shares". This form of capital is the UK's version of variable capital and is

1 In this report the word "statutes" is used to refer to the constitutional document which governs a particular business. The actual documents are: the articles of companies, the rules of IPS's, and the partnership agreement in an LLP or unincorporated partnership

not available if a company is used. Historically it was used by members of the consumer co-operatives that dominated the UK Co-operative scene as an account into which money could be placed and from which it could be withdrawn. Members' patronage refunds would be credited to their share account and frequently left there as savings.

An IPS may have WSC but may, alternatively or in addition, have transferable shares or shares with neither feature - which then operates as a form of membership fee (s 1 & schedule 1 para 9 IPSA 1965).

Like any other business, co-operatives, whatever business structure they use, may borrow money on a long or short term basis and with or without providing security over assets. So long as a business is empowered by its statutes to borrow, the question of how that is done is a matter of contract between borrowers and lender. Similarly, retained earnings are a source of business capital open to any business and have traditionally been significant for UK co-operatives.

1.3. Where are Cooperative Financial Structure Rules Found?

Most rules about the financial structure of UK co-operatives are laid down in the statutes of each co-operative. In the case of co-operatives using the IPS structure little specific provision is found in legislation but the “bona fide co-operative” test (above) always applies. For those operating as companies, the Companies Act 2006 lays down detailed rules about share capital, debentures and the source of any distributions to the members of the company – see Parts 17 to 19 and 23 of CA 2006. For IPS's, the gap left by the absence of such detailed legislative provisions is filled by judge made rules developed for companies before the Companies Acts were amended to contain such provisions. This report concentrates predominantly on IPS's although brief reference is made to the rules governing other business structures when appropriate.

The rules regarding accounting standards for co-operatives registered as IPS's are based on the concept of accounts providing a “true and fair view” of the position of the IPS – ss1-3 F & IPSA 1968. For IPS's, there is little more by way of detailed legal provision about accounting treatment and the detail is a matter for the accounting standards applied by professional accountants. They generally apply “International Financial Reporting Standards as adopted by the EU” as their financial reporting framework to meet the “true and fair view” legal

requirement – see, for example, the independent auditor's report, in The Co-operative Group Annual Report 2012 at page 53 http://www.co-operative.coop/Corporate/PDFs/Annual-Report/2012/TCG_Annual-Report-2012.pdf. The application of IFRS in the UK is through the standards set by the Financial Reporting Council known as UK GAAP – http://frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/The-future-of-UK-GAAP.aspx. The interpretation applicable to whether co-operative shares can be classed as equity, IFRIC 2 (see http://www.iasplus.com/en/standards/ifric/ifric2) applies in the UK through the availability in the co-operative's statute of an unconditional right for the board to refuse redemption (withdrawal) of shares and that standard is used to give the “true and fair view” require dby the legislation..

The UK tax system acknowledges the particular nature of co-operatives in two ways. One focuses on the industrial and provident IPS legal structure. The other is concerned with the reality of *fully* mutual trading between the members, regardless of the precise legal structure involved.

Like companies, IPS's are subject to Corporation Tax on annual “profits”. However, for IPS's, unlike companies, the interest paid on shares by an IPS is deducted in calculating the “profit” or loss for this purpose. An IPS which carries on a trade can also deduct the full amount of any patronage refund on a member's transactions with the IPS, regardless of what proportion of their trade is with members. Such deductions are not available to co-operatives using other corporate forms – ss 132 & 499 Corporation Tax Act 2009.

Under UK tax law, any business that it is not making “profits” because its trade with its members is fully mutual is exempt from any tax levied on “profits”. That will usually be corporation tax. This principle is laid down in case law and applied applied by the tax authorities who set out their approach in administrative guidelines– Ayrshire Employers' Mutual Insurance Association Ltd v Inland Revenue [1946] SC HL 1. and HMRC Company Taxation Manual (CTM) 40950 to 4098 http://www.hmrc.gov.uk/manuals/ctmanual/CTM40950.htm. Unincorporated groups, companies and IPS's gain the mutual trading exemption as long as the contributors to, and recipients of any surplus are identical, all of the surplus goes back to contributors according to the amount of business they do with the body, on winding up the amount distributed to

contributors bears a reasonable relationship to their contribution, and the members control the common fund. The exemption only applies to trade with members and not to trade with non-members or gains such as income from property ownership or bank interest. No capital allowances are available for capital expenditure and no tax relief is available for losses made in the mutual trading[2].

2. Cooperative share capital

2.1. The essential or non-essential nature of cooperative share capital

A co-operative registering under the IPSA 1965 can only confer limited liability on its members on the basis of share capital. That is the measure of the limited liability of the member (ss3 & 57 IPSA 1965). However, the absence of any substantial minimum share capital holding requirement for either the IPS or a member means that shares of minimal value can be used as a token of membership rather than a source of capital.

If other structures are used, it is possible to have no share capital whatsoever. Under the Companies Act 2006, a company with the liability of its members limited by guarantee can be established but may not have share capital (ss3,5 & 16 (1)-(3) Companies Act 2006). The LLP structure registered under the LLPA 2000 provides a corporate body and limited liability for members in return for the public disclosure of financial information but does not have share capital of the kind found in IPS's and companies (s 1 (2) & (4) LLPA 2000 and SI 2008/1911).

The absence of any substantial minimum share capital requirement for any legal structure other than a public limited company permits the use of a share as a non-returnable and non transferable membership fee in an IPS, a company or a partnership – see paragraph 2.4.

The nature of share capital has been defined in case law as follows:

> "A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se...."

Farwell J in *Borland's Trustee v Steel* [1901] Ch 279 at 288.

2 See Snaith I United Kingdom in Cracogna D, Fici A and Henry Hagen (eds), International Handbook of Co-operative Law, para 35.11

Shares are classed as a form of property (called a chose in action) which confers on the holder the rights and duties in or arising from the statutes of the corporate body in which the share is held. Those statutes operate as a contract between all the members inter se and between each member and the corporate body itself as a legal person – s14 IPSA 1965 and s33 CA 2006. In a co-operative, that contract will reflect co-operative principles with limited return on capital and one member one vote.

2.2. Assets as a natural element of the cooperative

The member's share is an interest **in** the corporate body (see Borland's Trustee v Steel in para 2.1. above) which does not confer any direct rights over the corporate body's assets. Under UK law the question of assets focuses on the nature of the co-operative as a corporate body. The IPS, LLP or company owns the assets and has the liabilities of the business undertaking. The only assets the members own are any shares (or loan securities) they hold in the IPS or company and their ownership stake under the LLP partnership agreement. They do not directly own or have rights over the assets of the corporate body by virtue of their membership of that body – *Short v Treasury Commissioners* [1948] 1 KB 116, 122, CA.

The accounting rules will govern how the corporate body's assets are described in accounts (see para 2.1. above).

Those principles apply to any business. Similarly, neither companies nor IPS's are generally required by law to have any reserves but the statutes of the body may lay down such a requirement. Even for co-operatives, there is no legal requirement for indivisible reserves but IPS rules may establish restrictions on distributions and reserves for education or other purposes.

In the case of a IPS registered as a bencom or a company registered as a Community Interest Company (CIC) any distribution of surplus assets to members on dissolution and any distributions to members before that stage, by way of dividend on shares or interest on loans or otherwise, are regulated and limited – see for IPS's see FCA Notes referred to in paragraph 1.1. above and for the detailed rules applicable to CIC's see SI 2005/1788 regs 17 to 25.

In the case of an unincorporated partnership operating as a co-operative, assets will be owned by the individuals or corporate bodies that have formed the partnership as “tenants in common” and can be divided when the partnership is dissolved. The proportionate ownership

and terms for dissolution and distribution of the assets will be governed by the contract made by the parties on forming the unincorporated partnership and, if it is to use the word “co-operative” as part of its business name, must follow the FCA Note referred to in Para 1.1. above. In the absence of any contractual agreement (written spoken or by conduct) between the partners, the provisions of the Partnership Act 1890 will apply and all property of the partnership will be held equally by the partners – s24(1) Partnership Act 1890.

2.3. Regulating principles of cooperative share capital

As noted in paragraph 1.1. above the FCA requires that, where part of the business capital is the common property of the co-operative, members should receive only limited compensation (if any) on any share or loan capital which they subscribe and that interest on share and loan capital generally must not be more than a rate necessary to obtain and retain enough capital to run the business. When combined with the requirements that any distribution to members of a mutual co-operative should be by way of patronage refund and that members' voting rights should not be linked to their capital holding, this reflects the ICA Principles .

The rules for general interest co-operatives depend on the legal structure used. In the case of a bencom, there should be no distribution to members at all on the dissolution of the IPS from annual profits. The payment of interest on shares or member loans is permitted but must not be “more than a reasonable rate necessary to obtain and retain enough capital to run the business” - see FCA Note quoted at para 1.1. A CIC, on the other hand, is permitted to pay dividend on shares and interest on members' loans, within limits laid down by law - see the *Community Interest Company Regulations* 2005 SI 2005/1788 regs 17 to 25. A CIC is prohibited from transferring assets other than for full value other than to another “asset locked” body - see the *Community Interest Company Regulations* 2005 SI 2005/1788 paragraph 1 of each of schedules 1 to 3.

A significant issue affecting the UK rules on capital is the silence of the legislation applicable to IPS's compared with the Companies Act 2006 on matters of capital maintenance.

Principle of Determination The IPSA 1965 requires the rules of IPS's to provide for:

- the terms of admission of members (which will include holding at least one share),
- the maximum limit on a member's shareholding in the IPS (at or lower than the maximum laid down by law),
- whether the shares or any of them are transferable or withdrawable and
- either provision for the form of transfer and its registration with the consent of the committee or provision for mode of withdrawal and payment of the balance.

- s 1(1)(b) and Schedule 1 paras 4,7, & 9 of IPSA 1965. Rules will in fact designate the unit of value of each share. The legislation is silent on their divisibility.

On the *Principle of Publicity*, the register of members of a IPS will contain a record of the number of shares held by each member but only the member can discover the value of his own share account - ss 44 & 46 IPSA 1965. However, the accounts prepared by the IPS, filed with the FCA each year and displayed at the registered office will contain in the balance sheet the total value of the IPS's share capital on the date of the balance sheet and that information is open to public inspection – ss39-40 of IPSA 1965, and ss1-4 of F & IPSA 1968. In the case of a company similar rules apply but the whole register of members is usually publicly available – ss113-128 CA 2006.

On the question addressed in UK law as “maintenance of capital” the legislation governing IPS's is largely silent and so the case law developed for companies before company legislation addressed it applies. For companies, those issues are now dealt with in the legislation. As a result, on the *Principle of Correspondence,* IPS's are governed by case law rules. Where cash is paid, the shares can be issued as “partly paid” if the statutes of the IPS or company permit that, in which case, the unpaid balance must be paid when it is “called up” by the directors. However, any amount credited as paid up on shares must actually have been paid to the company or IPS – s 580(1) CA 2006 (for companies) and *Ooregum Mining Co of India v Roper* [1892] AC 125. Where shares are issued in return for non-cash consideration such as goods, land, services, or a business undertaking, both IPS's and private companies are governed by case law rules which do not require prior independent expert valuation of the non-cash consideration. The valuation can only be questioned if dishonesty or negligence sufficient to invalidate any contract is established – *Re Wragg Ltd* [1897] 1 Ch 796. In the case of a PLC,

the CA 2006 requires an advance independent expert valuation report which is made available to company members and formally registered – ss 593-597 CA 2006.

2.4. The legal minimum cooperative share capital

The only minimum capital requirement for any UK business structure is the requirement that a public limited company should have a minimum allotted share capital of £50,000 - s 762 Companies Act 2006. Co-operatives are unlikely to use that legal form so no minimum capital requirement will apply to them other than the need to have at least one share per member as a means of limiting liability which theoretically amounts to a minimum of £0.03p (£0.01p x 3) . A co-operative that uses the CLG structure is unable to have any share capital - s 5 CA 2006.

2.5. The variability of share capital

For IPS's, the legislation limits holdings of WSC by any member other than another IPS to a maximum of £20,000. The UK Government is currently consulting on the possibility of to raising that limit to at least £31,000 (see HM Treasury Open Consultation Industrial and Provident IPS's: Growth Through Co-operation at page 8 http://www.iansnaith.com/wp-content/blogs.dir/8/files/2012/12/HMT-Consultn-IPS-07-09.13.pdf). Since January 2012 no such limit has applied to non-withdrawable shares in a IPS - section 6 IPSA 1965 as amended by SI 2011/2687. A IPS's rules may impose a lower maximum limit on holdings of withdrawable share capital and limits on holdings of other types of share. They can also limit the times at which withdrawal of share capital is possible, empower the board to suspend all withdrawals, or otherwise lay down conditions, such as a minimum notice period, for a withdrawal.

An IPS using WSC is prohibited from engaging in the business of banking other than as a credit union – s 7 IPSA 1965 and s 4(1) & Sched 1 para 8 CUA 1979.

Shares in a IPS not designated as withdrawable cannot currently be redeemed or bought back by the IPS itself – *Trevor v Whitworth* (1887) L.R. 12 App Cas. 409. However, in July 2013, a private member's Bill was presented to parliament by Lord Naseby which would empower the Government to use subordinate legislation to permit the issue of redeemable shares by IPS's as non-withdrawable share capital and to provide the same creditor protection as applies to companies that issue redeemable shares (http://services.parliament.uk/bills/2013-14/mutualsredeemableshares.html).

Withdrawable share capital in IPS's is exempt from anti-money laundering rules (reg 4(1)(a) SI2007/2157), financial promotion rules (art 4 & Sch 1 para 14 SI2005/1529) and the regulatory requirements arising from deposit taking (art 4 Sch 1 para 24 SI 2001/1201)

2.6. The functions of share capital

In the event of insolvency, the share capital of a co-operative, whether it uses a IPS or a company legal structure, serves as risk capital. Unless all debts, liabilities and costs of the insolvency procedure are paid off the members as owners lose their capital. As a result, it represents a cushion for creditors and affects the credit rating of the co-operative on the markets.

In a winding up, past members of either an IPS or a company, whose membership ended within a year before the beginning of the insolvency procedure, are liable to contribute towards paying debts incurred while they were members up to the amount unpaid on any shares they held - s 57 IPSA 1965 and s74 IA 1986. That rule applies to both companies and IPS's but impacts particularly on the WSC of IPS's as a member who cashes in withdrawable shares within a year before insolvency may have to pay back some or all of the amount withdrawn.

For a co-operative using an IPS or a company limited by shares, shareholding is the only means by which a person can become a member – ss3 & 57 IPSA 1965 and ss3(2) & 8(1)(b) CA 2006. If a co-operative uses either a company limited by guarantee structure or a limited liability partnership there can be no share capital and so it does not perform that function – ss3(3) & 5(1) CA 2006 and LLPA 2000.

Share capital in a IPS or a company limited by shares serves as the measure of, and limitation on, the member's liability for business debts – see para 2.1. (above).

The co-operative requirement which limits the return on capital and provides votes to members and not shares leads co-operatives to rely heavily on loan capital or retained profits.

Under the rules on accounting, share capital can only be regarded as “equity” for the purpose of assessing the capital gearing of the co-operative if the board of the co-operative has the power to refuse to redeem it - IFRIC D8 on FRS25 (UK) IAS 32 of 30.06.2004 (http://www.iasplus.com/en/standards/ifric/ifric2).

The issue of the treatment of creditors is generally dealt with by the theory that it is for them to use the publicly available information to choose whether or not to contract with the corporate body and, once they have made the contract, their only protection is the order in which debts and share capital are paid out on insolvency.

3. Member contributions to capital

3.1. Obligation to pay up capital

The amount of any minimum required holding is a matter for the statutes of the co-operative. The rules on payment on shares are addressed in paragraph 2.3 (above).

3.2. Types of capital contribution

Sources of capital for any business are loans, shares or retained earnings. In terms of member contribution that will only be shares or loans. As noted at para 00 above, shares in an IPS can be withdrawable or transferable. In a company variable share capital is not possible. Para 1.1. explains the criteria used to determine whether an enterprise is co-operative.

3.3. Nature of the contribution

See para 2.3 above.

3.4. Recording

See para 2.3 above.

3.5. Amount

See para 2.4. above. Depending on the nature of the co-operative, e.g. consumer, worker, or housing the FCA might regard an excessive minimum capital requirement as an inhibition on open membership and refuse to register the rule that imposed it. Otherwise, the matter of contributions is left to the statutes of the IPS or company.

3.6. Payment

This is a matter for the statutes of a co-operative, subject to the matters discussed at para 2.3. above.

3.7. The value of member contribution

Section 14(2) of IPSA 1965 requires an existing member's individual written agreement to any amendment to the rules of a IPS which requires him to increase his shareholding or otherwise increases his liability to contribute to the loan or share capital of the IPS. That permission is in addition to the majority required under the statutes for any rule amendment – a matter left to the statutes of a IPS and not laid down in the legislation. If a company is used, amendments to the articles generally require a majority of 75% of the votes cast or a higher majority laid down in the company's statutes – ss21-27 & 283 CA 2006.

Otherwise matters such as the conversion of reserves, reduction of share capital by the allocation of losses are all left to the statutes or the terms of issue of the shares for a IPS, subject to the requirements of the FCA for a "bona fide co-operative" (see para 1.1. above). In the case of a company limited by shares detailed rules about the variation of capital by division or consolidation or the redemption of purchase by the company of its shares apply – see ss 641-737 CA 2006 and para 2.3. (above).

3.8. Compensation

The amount of interest paid on shares, the distribution of profits, patronage refunds to members from any trading surplus, the existence and level of reserves and their potential use or distribution to members are not specifically governed by IPS legislation. Subject, as always, to the requirement that the FCA is satisfied that the rules are appropriate for a bona fide co-operative, this is left to the statutes of the co-operative. The FCA Information on this question is concerned about the issue of the reward for capital:

> **Interest on Share and Loan Capital – "**Where part of the business capital is the common property of the co-operative, members should receive only limited compensation (if any) on any share or loan capital which they subscribe. Interest on share and loan capital must not be more than a rate necessary to obtain and retain enough capital to run the business..……..."
>
> **Profits – "**If the rules of the IPS allow profits to be distributed, they must be distributed amongst the members in line with those rules. Each member should receive an amount that reflects the extent to which they have traded with the IPS or taken part in its business……..."

The same criteria will apply to the use of the word “co-operative” as part of a business or trading name by a company, partnership or individual.

If a company structure is used for a co-operative specific statutory rules about the source of any distribution to share holders will apply to ensure that only profits available for the purpose are used (ss 829-853 CA 2006). Those specific statutory rules do not apply to IPS's but it seems likely that the gap will be filled by similar judge made rules which were replaced by those Companies Act provisions. The statutory definition applicable to companies defines profits available for the purpose of distribution as

> “accumulated realised profits so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made”

- s830(2) CA 2006.

This definition, although it may not reflect the legal provision strictly applicable to IPS's is applied to them on the basis of accounting standards as discussed in para 1.3. above. The common law definition may permit a distribution without taking account of accumulated realised losses providing the payment would not make the society insolvent – *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266.

3.9. Redemption

This is subject to the statutes of the co-operative and the rules of common law or, for companies, the legislation – see para 2.5.

3.10.Transfer

For IPS's, IPSA 1965 Sched 1 para 9 on transferable shares indicates that committee approval is required for each inter vivos transfer. However, it may be possible for this power to be delegated to an official or employee if the committee has set the policy. The statutes may lay down more detailed procedures and formalities. For a company, there are no special rules for co-operatives using that structure and the statutes of each company will generally lay down the procedures and rules.

Transfer mortis causa takes place under normal probate rules and in accordance with the will or intestacy of the holder of the shares, subject to any provisions laid down in the statutes of

the IPS or company or the terms of issue of the shares. The property inherited on the death of the holder will be defined by the statues or terms of issue which fix the rights attached to the shares and any limits on them. In the case of IPS's a parallel system for transfer mortis causa applies where the amounts held in the IPS are limited. This permits the member to record a "nomination" with the IPS which indicates the recipient of the shares on the death of the member – s 23 IPSA 1965.

3.11. Political and economic rights granted by member contributions to share capital

In an IPS or a company limited by shares, membership depends on holding at least 1 share but this is formalistic. All the rights conferred by the statutes of the corporate body only apply to someone holding a share. A co-operative may use a CLG or an LLP and then membership will not depend on holding any share as the co-operative will be unable to have any share capital – s5 CA 2006.

4. Reserves

No obligation to create reserves exists in the UK and the issue is left to the statutes of the IPS or the company unless special regulatory rules such as those applicable to banks and insurance businesses apply.

5. Mutualist Capital (*masa de gestión económica*)

No such concept exists as an obligatory rule in UK Law. The IPS or other corporate body used by the co-operative for its legal structure is a legal person – s3 IPSA 1965, s1(2) LLPA 2000 & s16 CA 2006. It owns all property and the members have whatever rights and duties are laid down in the statutes or the terms on which any shares were issued. If the co-operative's statutes require disinterested distribution that denies individual members any rights to a surplus left on a solvent dissolution of the corporate body. The question of what property rights the IPS or company as a corporate body has over members' property is a matter of contractual agreement between members and the legal person of the IPS. For example, the corporate body could act as the agent of the members to sell members' property to others or as owner of property that the members transfer to it.

The key issue is whether members can change the statutes so as to permit distribution to individual members of any surplus. In the case of an IPS, they can always convert it into a

company and then distribute if the appropriate majority uses the correct procedure – s 52 IPSA 1965. A bencom can choose to impose an “asset lock” on itself to avoid that possibility and a company registered as a CIC is required to so so - see para 2.2. Any company can entrench provisions of its statutes by making them impossible to change or requiring a special high majority for change (above the usual 75%). However, a unanimous decision of all the members can always amend the statutes – s22 CA 2006. In the case of an IPS, its statutes cannot exclude the power conferred by the legislation to convert it into a company or otherwise reorganise itself but it is possible to impose a high quorum in the statutes for the meeting that will make the decision – s 52 IPSAs

In the case of a co-operative choosing not to use a corporate body, a trust mechanism would have to be employed to dedicate the assets to a particular purpose and to restrict the distribution of the assets among the members as partners in the business.

6. Revenue from cooperative economic activity. How it is determined and allocated.

In the case of co-operatives using the IPS structure, this question is determined by a combination of the statutes of the co-operative and the accounting rules. As always, the statutes are subject to the bona fide co-operative test on registration of the IPS or later amendment of the statutes (see para 1.1.). If a company structure is used CA 2006 lay down detailed rules about what defines profits available for distribution and the equivalent common law rules applicable to IPS's are similar but slightly less strict – para 3.8.

7. Financing through retained cooperative refund

The co-operative's statutes will determine whether and when any co-operative refund is payable to the members. They will usually confer power on the board of directors to recommend a level of distribution for approval or reduction (but not increase) by the general meeting.

8. **Member contributions to purposes other than share and mutualist capital**

This is a matter for the co-op's statutes and contractual arrangements between members and their co-op. Membership fees are possible as are restrictions on withdrawal of WSC and the accumulation of reserves from retained profits. Member loans to the co-op are allowed under freedom of contract but are subject to the FCA restrictions on returns - see para 1.1.

9. **Other sources of finance** (including investor members)

In 2006, the FSA developed a policy on the admission of non-user investor members. It is based on the provisions of the SCE regulation. The FSA document permits co-operatives to have non-user investor members who hold “Investor Shares”, subject to restrictions to protect the interests of user members. These include restricted voting rights for investor members, compliance with applicable regulatory requirements under FSMA 2000, and an overriding requirement that the society remains, in the FCA’s view, a “bona fide co-operative” (*Investor Membership of Co-operatives registered under the Industrial and Provident Societies Act 1965 A Policy Note* by Michael Cook and Ramona Taylor, Financial Services Authority, 2006 https://docs.google.com/file/d/0B3k1mIyJumBSTXRCN1RMOXIyaXc/edit). Also broad possibilities for borrowing exist as a corporate body has full power to issue loan securities or bonds, to give security over its assets and to enter into other contracts to receive credit or borrow money. The only restriction will be on the level of return as the FCA Note will have to be followed (see para 1.1.). In the case of a CIC, the return on loans is limited by legal rules enforced by the CIC Regulator(see para 2.3. above).

10. Credit sections in the financing of cooperatives

As a corporate body the IPS is one legal entity but subsidiary IPS's or companies are common – usually wholly owned. As part of democratic control, many consumer co-operatives will use a regional committee system to elect directors and oversee relations with members but these arrangements are to be found in the statutes of each co-operative. I am not aware of any use of “credit sections” as described in the guidance.

11. Relations between cooperatives and credit cooperatives

This is entirely a matter of the general law of contract and of the regulatory rules applicable to banks and to credit unions.

12. Cooperative and cooperator liability

If registered as a corporate body, the co-operative members will stand to lose only the amount of their share capital. However, as with other small businesses, creditors of smaller co-operatives may require personal contractual guarantees by members or directors of certain debts and liabilities of the corporate body (e.g. bank loans and liabilities under a lease of land)

as a condition of entering the contract with the co-operative. Any shares held by members are their property and so could be taken in the case of member insolvency but that would be subject to the terms on which the member holds them under the IPS's rules. All IPS funds and assets are available to creditors in its insolvency, unless they have been placed on trust, in which case they can only be used for the benefit of the beneficiaries of the trust. That would be very unusual and the existence of such an arrangement would be known to creditors before they contracted with the IPS, as a result of which they would be less likely to lend to it. If a IPS operates as an agent to make contracts on behalf of its members, again an unusual arrangement, then the member will be fully liable on the contract made and the IPS will not be liable under the Law of Agency.

13. Cooperative autonomy

There are no special legal rules about relations between co-operatives and public authorities. Relations with non-user investor members will be governed by the statutes of the co-operative which, for IPS's, will be subject to the 2006 FSA statement on non-user investor members (see para 9 above). The FCA Note on registration[3] provides that "control of the society lies with all members" and, while that statement is made in the context of democratic control, it might provide a basis for a refusal to register a co-operative which was clearly under the control of some other body, whether a state body or a provider of capital.

14. Winding-up and liquidation

The insolvency rules applicable to the winding up and dissolution of co-operatives are broadly similar across all business structures and are to be found in the Insolvency Act 1986 as applied to IPS's by s 55 of IPSA 1965. They provide for a creditors' voluntary liquidation to begin by a members' resolution with control by creditors of the process, including the appointment of a qualified insolvency practitioner to act as liquidator – ss 84-90 & 97-106 IA 1986. Alternatively, the process can begin by court order (a compulsory winding up) on the application of a creditor, normally on the ground that the co-operative is insolvent either

3 FCA & PRA, Mutual IPS's Registration Form Notes downloaded from http://www.fca.org.uk/your-fca/documents/forms/registering-a-new-industrial-and-provident-IPS-notes on 29.09.2013 at page s 8-9.

because it cannot pay its debts as they fall due or, less commonly, because its liabilities exceed its assets – ss122-160 IA 1986. The process of liquidation then follows the pattern laid down in the Insolvency Act 1986 with the liquidator gathering and realising all assets and distributing the proceeds to creditors in accordance with their legal rights – broadly, secured creditors first, then unsecured creditors but with a preferential position for employees in respect of unpaid wages and certain other employment law rights - ss 107-116 &163-444 IA 1986.

At present, the main discrepancy in treatment between different legal structures is that companies and partnerships can benefit from rescue procedures known as the administration procedure and a company voluntary arrangement (CVA) which provide a period of moritorium during which a qualified insolvency practitioner can continue the business protected from creditors' claims and prepare recommendations with a view to rescuing all or part of the business, making an arrangement with its creditors, or realising greater value for creditors in an subsequent liquidation. Since the Enterprise Act 2002, that procedure has been the only redress for creditors with a floating charge over company assets which includes the right to appoint an official (a receiver) to realise their security.

IPS's cannot use the administration or CVA procedures and, where (as is very common) they have given a floating charge over assets, they are subject to receivership, a procedure mainly governed by case law, under which the insolvency practitioner acting as receiver owes legal duties only to the appointing secured creditor. This has been a serious disadvantage faced by those co-operatives which use the IPS structure as it makes rescue less likely (there is no moritorium) and places unsecured creditors at a disadvantage compared with their position in a company administration – Dairy Farmers of Britain [2009] EWHC 1389 Ch http://www.bailii.org/ew/cases/EWHC/Ch/2009/1389.html .

In 2013 proposals were announced to apply the administration procedure to IPS's in the same way that it applies to companies – HM Treasury Open Consultation, “Growth Through Co-operation” July 2013 https://www.gov.uk/government/consultations/industrial-and-provident-societies-growth-through-co-operation/industrial-and-provident-societies-growth-through-co-operation. That will remedy the disadvantage suffered by IPS's – Citation. By definition, in any case of insolvency a co-operative using any legal form will have no surplus to distribute to members as all assets will be used to pay creditors. Co-operative mambers are then in the same

position as company shareholders in this respect and co-operatives enjoy no special protection even if they would apply a disinterested distribution to any remaining surplus. This is because all assets of the co-operative are subject to the claims of its creditors.

On the solvent dissolution of a co-operative, the destination of any surplus assets is governed by the its statutes and most co-operatives provide for transfer to other co-operatives, co-operative organisations or charities and other disinterested purposes. However, a distribution among the members on the basis of their transactions with the co-operative over a fixed period near the end of the its life has been allowed in IPS rules and is used by some agricultural IPS's. There is some danger that, in the absence of any provision whatsoever in the IPS's rules, the applicable rules about the destination of a surplus on solvent liquidation might lead to distribution according to shareholding since the applicable rules are to be found in the insolvency regime applicable to companies. As a result, the inclusion of an appropriate provision in IPS rules is particularly important.

Any member of either an IPS or a company can apply to court for a winding up order in respect of a solvent co-operative on the grounds that the court considers it just and equitable that it should be wound up – s 122(g) IA 1986. However, courts are reluctant to grant this remedy if the business is functioning and are required to refuse the winding up if they believe that another remedy is available so that the member is behaving unreasonably in seeking to wind the company up – 125(2) IA 1986. As a result, this has never, as far as I am aware, been used in the case of a co-operative. If a co-operative is registered as a company, a member may petition for a remedy if they prove in court that the company is being run in a way that is unfairly prejudicial to that member – s 994 CA2006. That remedy is not available in an IPS and is normally a means for a minority to force a buy out by the majority if the company statutes make no adequate provision for that and there is no market in the shares. The remedy is only normally granted where the applicant has suffered due to unlawful behaviour by the majority such as a serious breach of directors' duties causing them financial loss or where there is evidence of an understanding or agreement not reflected in the statutes which has been broken by the other members – *O'Neill v Phillips* [1999] 1 WLR 1092. I know of no case where this remedy has been applied to a co-operative using the company structure. It would

only be worth suing in a case where the minority had a significant financial stake in the company.

IPS's registered on the basis of operating for the benefit of the community are permitted, on formation or by later rule amendment, to “lock” the assets of the IPS in for the purpose for which the IPS is established. This restricts the possibility of converting the IPS into a company or even a IPS registered as a co-operative and closely controls the disposal of any assets on dissolution or during the life of the IPS - section 1 Co-operatives and Community Benefit IPS's Act 2003 and see The Community Benefit IPS's (Restriction on Use of Assets) Regulations 2006 SI 2006/264. This level of protection of assets dedicated to the purpose of community benefit is similar to the rules that govern any company registered as a Community Interest Companies (CIC).

Such protection is not available to IPS's registered as bona fide co-operatives - section 1 Co-operatives and Community Benefit IPS's Act 2003. The legal protection of any surplus in mutuals and co-operatives and the application of the principle of “disinterested distribution” on dissolution has been recommended by the 2012 Report of the Ownership Commission which examined issues surrounding business ownership across the UK economy and its effects - Recommendation 3 Ownership Commission, Plurality, Stewardship and Engagement, March 2012, MUTUO, London http://ownershipcomm.org/ Chapter 4 at pgs 76-94 & 96.

15. General Interest Co-operatives

See the treatment of such co-operatives registered as bencoms or CIC's throughout this report and, in particular, the Note at para 1.1. above.

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October 2013

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