Protecting Public and Community Assets

Cliff Mills

It is currently not possible to protect public or community assets in a corporate entity (apart from a charity), so that they are safe and can remain committed to a social purpose.

There are strong reasons why this situation should be addressed, one reason being the need to provide an appropriate corporate vehicle for delivering public services and for new social enterprises.

The situation can be addressed by limited change to legislation covering industrial and provident societies. In the Parliamentary debates on the Industrial and Provident Societies Act 2002, the Government expressed support for achieving this objective.

Introduction

It is a little known fact, but it is not possible in English law to put assets into a corporate entity, and to leave them there in the certain knowledge that they will remain committed to their original purpose (unless it is a charity or complex trust arrangements are used).

What this means in practice is that if there is a desire to transfer public or community assets into a new body, or if two or three people wish to donate funds to launch a social enterprise, there can be no certainty that the members in the future will not simply help themselves to those assets.

Does this matter? Can it be changed? If it can be, what are the issues involved?

Does it matter?

I believe it does, for moral, social and political reasons.

First of all the moral argument. The building society movement, like other parts of the mutual movement which developed in the late eighteenth and early nineteenth centuries, started as a self-help movement to enable ordinary

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people to have access to benefits not otherwise available to them.

By the last quarter of the twentieth century, for commercial reasons a number of building societies felt the need to transform themselves into a different type of corporate structure, namely a public limited company with private shareholders. This resulted in a distribution of the surplus assets accumulated over many decades, and produced "windfall" profits for those who happened to be members at the time.

Those who had traded with the building societies over previous generations had not done so with the intention of benefiting the generation in charge in the late twentieth century. They brought their trade to the society as part of a self-help initiative for their own benefit which would help others in the future.

The result of the 'demutualisation' of building societies was to change an organisation trading for the benefit of its members (savers and borrowers) and the wider community including future generations, to one trading for the benefit of investors (the shareholders for the time being).

There is a moral argument that the intentions of the surplus generated from the trade of former members should have been retained for the benefit of others, and should not have been given away to a particular group of members as a windfall profit. The very term 'windfall profit' accurately denotes something unexpected and unearned.

Turning to the social argument, the growing Social Enterprise Movement needs some form of legal structure which will ensure that at some time in the future, successful social enterprises will not produce windfall profits for investors. Indeed to encourage the start up and growth of such organisations, it would help to attract and reassure stakeholders in new social enterprises if they could be sure that their contribution (whatever form it takes) is locked in and will benefit the community in perpetuity.

The encouragement of the development of new social enterprises is an important priority, and a pressing need to assist in delivering the Government's objectives in a number of areas such as childcare.

Turning finally to the political argument, one of the most important issues facing the Government at present concerns the appropriate mechanism for delivering public services. In the UK we have moved from transport and utility services owned by private enterprise, through nationalisation to state-owned and controlled services; and then back again in a number of areas to privately-owned services with a state-appointed regulator. The latter has not been an overwhelming success, and there are those who believe that further transition is necessary. A move to a community-based form of ownership is one possibility.

In those areas where privatisation has not already taken place on the same basis (e.g., health) alternative approaches are actively being explored.

Whether in the context of services which are still owned and controlled by the state, or those recently privatised, there remains an unanswered question about the most appropriate body for owning public or community assets. Proper protection is needed to ensure that such assets can be held in a way that they remain committed to serving the community and safe from predators. This cannot currently be achieved.

It therefore does matter, for moral, social and political reasons that an appropriate legal form does not exist to achieve this. Can the situation be changed?

Can the situation be changed?

The precise nature of the probiem to be addressed needs to be explained. It is helpful to start by looking at the normal form of ownership of businesses, namely the limited company model.

A company is owned by its shareholders, and normally the owner of a share, as well as having an entitlement to a dividend from the trade of the company, owns through the shareholding an underlying proportionate share in the net assets of the business. It may be possible for the shareholder to sell their stake for a value equivalent to a proportionate value of the net assets (if there is a market in such shares). Alternatively, it is possible for the shareholders as a body to sell assets and distribute the proceeds to themselves, or to

sell the entire business and assets to a purchaser, and having turned the assets of the company into cash, to wind up the company and pay back to themselves the entire value of the company pro rata their shareholding.

The success of companies as the vehicle for owning businesses is due in no small part to this ability for investors to realise their profits. The flexibility for shareholders to realise their investment is an important feature of the company model, and clearly one of the incentives for investment. In this respect, the company model is diametrically opposed to the objective we are seeking to achieve, namely the desire to prevent the sale of assets and the transfer of value into the hands of investors.

It is of course possible to protect assets and create a legal form which is effectively protected against predatory interests - charity law provides this opportunity. However, charity law is restricted to organisations which are operating for charitable purposes,· a term which is relatively narrow (mainly the relief of financial hardship, the advancement of education or the advancement of religion). Whilst there are some public services or social enterprises which can operate as charities, there are many which cannot. Furthermore, the statutory framework which has been established for charities is often inappropriate for many such businesses, and it seems unlikely that charity law provides the answer to the problem. Other forms of trust based mechanism are complex and both costly and difficult to set up. They do not meet the need for a simple, inexpensive corporate form which achieves the community benefit purpose without being part of more elaborate arrangements.

What are the alternative corporate forms to companies?

I have referred to building societies already, and mentioned that the building society movement was part of the mutual movement which developed in the eighteenth and nineteenth centuries. Building societies have their own separate legislation which governs those businesses set up to operate in this particular field.

The other form of corporate entity which is generally

available for a wide range of trading activities is the industrial and provident society. Originally providing the statutory authority to incorporate co-operative societies, the industrial and provident society legislation was amended in 1939 to include societies established to trade for the benefit of the community. This change in the legislation took place because people were trying to avoid the growing levels of regulation which Parliament was applying to companies as company law was evolving (e.g., prospectus requirements) by operating through industrial and provident societies. This resulted in a tighter definition of those organisations which were entitled to register as industrial and provident societies, and gave us the two categories which exist today - bona fide co-operatives and community benefit societies.

Both company law and industrial and provident law create a framework under which individuals wishing to incorporate a legal entity can do so subject to the arrangements set out in the relevant legislation. Unlike companies which register with the Registrar of Companies under the Companies Act, industrial and provident societies register with the Financial Services Authority (previously the Registrar of Friendly Societies) under the Industrial and Provident Societies Acts.

Since the nineteenth century, both company law and industrial and provident society law have provided the ability for one type of corporation to convert from one into the other, upon compliance with appropriate procedure. For example, industrial and provident society law provides that upon a resolution passed by the requisite majority of members, an industrial and provident society can convert into a company. It may seem relatively inconsequential that there exists, somewhere in the small print of the legislation, the ability for each legal form to convert into the other. However, this is the heart of the matter, and the significance of this power to convert needs to be seen in the context of the purpose of the two different types of corporation, the company and the industrial and provident society.

First, let us consider this issue in the context of the co-operative sector.

In order to be allowed to register a co-operative society, the subscribers must demonstrate to the satisfaction of the

FSA that the rules of the intended society will result in a 'bona fide co-operative'. The meaning of this phrase is interpreted by reference to the Co-operative Principles published the International Co-operative Alliance, but the essential principles include a limited return on share capital (the minimum to attract investment), one member one vote (whatever the number of shares owned), distributions (ie dividends) paid to members in accordance with trade or applied for other co-operative purposes such as education and member relations activities, and a distribution on winding-up similarly based upon trade rather than share ownership. Furthermore, shares in a co-operative society are not normally transferable.

The contrast between a co-operative and a company can immediately be seen. Company shareholders look for rewards based on the amount of money they invest. A co-operative society will only pay the minimum level of interest sufficient to attract the necessary share capital. Its surplus is to be distributed amongst those who trade with the society, and in proportion to that trade. It is therefore a corporate form in which customers and workers (ie those who trade with the organisation) have a much greater significance, and investors are comparatively unimportant.

The other type of industrial and provident society is the community benefit society. In order to register as a community benefit society, the subscribers must satisfy the Registrar that the business will be carried on for the benefit of the community and that there is some special reason to register as an industrial and provident society rather than as a company. The 'special reason' requirement owes its origin to the measures introduced in 1939 to stop those seeking to avoid the regulation of company law, and is an anti-avoidance provision. In practice, those seeking to register a community benefit society must satisfy the Financial Services Authority (FSA) that no benefits (whether by way of distribution of profits, or distribution of surplus on winding up) will go back to members, and that the entirety of the surplus generated by the organisation will be utilised to further its objects.

Once again, there are significant contrasts with a company. The members of a community benefit society can

derive no personal financial benefit from membership. The purpose of the organisation is to trade for the benefit of the community, and securing personal benefit has no place in that.

The significance of the ability to convert from company to industrial and provident society and vice versa can now be seen. Shareholders in a company who resolve to convert to a community benefit society (or a co-operative society) will be giving up something valuable, though if that is what they wish to do (and they are happy to accept the slightly more restrictive registration criteria required for an industrial and provident society), there is no reason why they should not do it. If the shareholders are entitled to wind up the company and give their proceeds to an organisation established to benefit the community, there is no reason why they should not be allowed to achieve the same by a process of conversion.

A logical conundrum

However, conversion the other way raises more difficult issues as the members of the organisation are not themselves entitled to all of the benefits - they are simply not theirs to give away (or appropriate to themselves). This is more obvious in a community benefit society, but it is true to some extent of co-operative societies as well (see further below). How can the members of a society established for the benefit of the community make a decision to appropriate its assets (to which they themselves are not entitled) to themselves?

It can now be seen that the very existence in the legislation of the ability to convert from a community benefit society (and arguably from a bona fide co-operative) to a company - at least without any form of external regulation - is a serious flaw. Indeed, what is the point of including in the registration criteria a prohibition or restrictions on distributing the profits of trade or the surplus on winding up to the members if the very mechanism to achieve this result by conversion into a company is contained in the legislation itself? It is something of a legal and logical nonsense.

Notwithstanding this logical conundrum, attempts to address the problem through amending legislation have until recently been firmly resisted by the Treasury, which retains responsibility for industrial and provident societies (responsibilities for companies resides with the Department of Trade & Industry).

It can be understood why, in an economy greatly dominated by the company legal form, the limited company should be regarded as the normal or natural form for owning businesses. For those (a small minority) who wish to hold a business in some other legal form, the Industrial and Provident Societies Act (IPSA) provides an adequate mechanism. However, if an appropriate majority of members of a society wish at any stage to change the legal form they had chosen and to opt for a company, it seems only fair and reasonable that they should be able to do so. So the argument goes.

In the early twenty first century, perhaps we are starting to see things differently. After some spectacular corporate failures, the increasing concern about structural difficulties in the company form (such as the conflict of interest involved when directors own shares), and a growing sense of unease about the huge businesses which dominate the world today, the need to find alternative forms of ownership for businesses is itself a high priority. Maybe another legal form (the industrial and provident society) is preferable for certain purposes; and maybe it is not always appropriate for the members of such a society to be able to convert it into a company. For the moral, social and political reasons set out above, it would now seem to be a good idea for there to exist a legal form which **cannot** be converted into a company.[1]

There has already been one notable example of such an idea being implemented in a particular sector, namely in social housing. Under the Housing Act 1996, a registered social landlord is unable to change its constitution without the permission of the Housing Corporation. This provides a mechanism for the protection of public funds, and provides an effective mechanism for regulation. However, it is only a sector-based mechanism linked to registration as a registered

social landlord. But it shows that the concept has some kind of precedent, that it has already been accepted, and that it works.

Interestingly, the retail co-operative movement has come up with its own form of protection. Many societies have written into their constitutions a provision that, upon a solvent dissolution, any surplus will not be distributed amongst its members, but passed to another co-operative society. Such protection is, of course, only as good as the next change to the constitution, subject to any provisions which the FSA permits to be included to make changing such provisions more difficult. They can never, however, override the provisions of IPSA which permits transfer of engagements or conversion to a company, and the subsequent liberation of the assets to the members.

Can the situation be changed?

The situation is of course capable of being changed. It will require an amendment to the provisions of the Industrial and Provident Societies Act 1965 to permit, in appropriate circumstances, new societies to be incorporated or the rules of existing societies to be changed to include relevant restrictions on conversion. It is simply a question of drafting.

The first serious attempt to change this area of the law occurred in the Industrial and Provident Societies Bill, a private members' bill promoted by Gareth Thomas MP. This bill has recently been enacted, but the clause dealing with what has become known as 'the asset lock' was removed at Report Stage because of Government opposition.

'Asset lock' is, in fact, a misnomer. The desire is not to prevent a society dealing with its assets and indeed ultimately realising them all for cash if that is what the directors of the society believe to be the best way to achieve the society's purpose and objects. The intention is to prevent the distribution of value (whether that be in cash or in any other form) to members for the time being, and to secure the value of the relevant assets to the purpose and object of the organisation.

There is only one real difficulty with an asset lock, and it is this. There is a legitimate concern that a situation could arise where a society containing such restrictions in its constitution was unable to change to a more appropriate legal form, and the assets or value represented by the assets owned by the society effectively became permanently locked and effectively unusable. Some form of safety mechanism is needed to unlock the situation if it ever arises.

It is right that this issue needs to be dealt with. It is not right that the issue should be a barrier to the development of this area of law to meet the needs of a great many situations where this eventuality will not arise.

Possible solutions

Crudely speaking, there are three potential mechanisms for addressing this problem.

The first solution is that, Parliament being sovereign, whatever structures it creates, it can dismantle. Clearly, however, it would not be satisfactory to have to return to Parliament to deal with the problem.

At the other end of the scale, provisions could be written into legislation providing a route-map for dealing with the problem. The success of this approach would depend upon the ability to define in a practical way the circumstances under which the mechanism would come into operation, and then defining appropriate procedures to be followed.

The third and middle course is to delegate authority to an appropriate body to unlock or to play a part in unlocking problem situations should they arise.

Both of these two latter approaches were canvassed in discussions on the Industrial and Provident Societies Bill. The first approach was to provide a simple mechanism within the bill itself. It enabled new community benefit societies, or existing community benefit societies subject to achieving an appropriate majority in favour, to adopt provisions which would achieve the necessary protection. The protection did three things:

(a) The prohibition of the distribution of a surplus on

dissolution to the members, and provision that on dissolution, the assets should only be distributed to either another community benefit society whose constitution contained the same protection, or to a charity;

(b) A provision that the rules dealing with (a) above could not be altered by the members of the society; and

(c) Provision that such a society could not transfer its engagements to or convert into a company or any other body unless that company or body had in its constitution the restrictions set out in (a) and (b) above.

These provisions were not considered to be sufficiently workable by Treasury officials, and the alternative option of using the FSA as a body to unlock or to play a part in unlocking problem situations was explored. This was based upon an existing power in the Industrial and Provident Societies Act for the Registrar of Friendly Societies (now the FSA) to determine the appropriate distribution of assets on a dissolution where no provision is contained in an instrument of dissolution. This also was regarded as an incomplete answer.

During the course of debate on the bill, the Government expressed support for the principle of irrevocably committing assets to the benefit of the community, though it was concerned to ensure that the practical problems were addressed. This marked a significant shift in attitude, away from one of hostility to one that required practical problems to be overcome. That being the case, there is now no excuse for not spending the necessary time to work out the solutions to this problem.

One other potential problem was referred to by the Government in debate, although it is not accepted that this is in fact an issue. It was suggested that some form of asset lock could deprive members of their rights and that this could invoke Article 1 of the European Convention of Human Rights.

First, it is appropriate to point out that an individual who becomes a member of a community benefit society with an

expectation of personal financial gain (or indeed any financial right other than possibly the right to repayment of share capital) is misguided because as a matter of law they are not entitled to receipt of any surplus. This is of course subject to the logical conundrum referred to above, namely the potential right of conversion to a company, which it has to be argued leaves outstanding the theoretical possibility of personal gain.

The argument (that the possibility of personal gain arising following a conversion itself amounts to a property right of which peaceful enjoyment was being infringed) is still incorrect for the following reasons. First, no asset lock would be introduced unless members of the society themselves voted by the appropriate majority to introduce such a provision (nothing is being imposed by the State). For existing societies, a high threshold of members is suggested. Where an existing society resolves by a resolution of its members to introduce an asset lock, an individual member has an opportunity to speak and influence the discussion. It is a feature of industrial and provident societies that the members retain the ability to change the rules of their society and any individual joining an industrial and provident society accepts by so doing that they are joining a society the constitution of which can be changed by its members. (For new societies, the issue does not arise at all because any person joining a society thereby accepts its constitution. If it contains an asset lock, they have accepted it.)

In any event, on a solvent dissolution of a society, the members of a society are entitled to decide by resolution that they will pass their asset to another community benefit organisation or a charity. Introducing this provision at an earlier stage in the life of a society is therefore only a difference of timing.

Conclusion

The Government is sympathetic to the idea of enabling asset-locking provisions to be introduced. There are some practical issues which need to be resolved, and these should be addressed without delay.

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Note

1 The recently published (September 2002) Strategy Unit Report *Private Action, Public Benefit* recommends that Community Benefit Societies have the option, following a vote of members, to be able to choose to protect their assets in perpetuity for a public purpose and prohibit conversion into a co-operative or a company.