

Distributions, and What it Means to be a Co-operative

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Background - Purpose

The payment of distributions by co-operative societies is an important part of the very purpose of existing as a co-operative. However, since more people are familiar with companies and what amounts to a distribution by a company, the distinctive nature of distributions by co-operatives is less well understood. This article intended to explain the differences.

Before turning to consider the specific matter of distributions, it is important to start by recognizing a key difference between the nature or purpose of co-operatives and companies. Although both have in common the features that they are incorporated with (usually) limited liability, and have independent legal personality, their reason for existence is different.

Looking first at a company, as Palmer puts it: "... the company is conceived as a form of organisation of private enterprise and as such is motivated by the profit motive".¹ The company provides a vehicle for investors to invest money with a view to making a return. This is to be achieved by the company carrying out the trade that is described in the objects clause of its memorandum of association. Company law has developed in ways which support this purpose, and through such legal principles as the fiduciary duty of company directors which requires them to act in the best interests of the company and effectively protect shareholder value, it ensures that earning a return for shareholders - delivering the purpose - is the legal priority in running a company.

The purpose of a co-operative is different. Whilst its objects rule will similarly set out the trade with which its members wish it to be engaged, its purpose in engaging in that trade is not to provide a reward to its investors. The purpose of a co-operative society is to serve the community in which it trades, and more particularly its members, by carrying on its chosen trade. The ICA Statement of Co-operative Values states that a co-operative is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise."²

It can therefore be seen that whilst a company and a co-operative

may both carry on the same trade, their purpose for doing so is different. The one does it with a view to providing a return to shareholders; the other does it in order to provide a service to its members/community.³

It has not been common for corporations to state their purpose expressly in their constitution. This situation is now changing. For example, the recently adopted rules of the Co-operative Group state that society's purpose in rule 3 as follows:

The purpose of the Society is to be a co-operative society serving its members in accordance with the Rules. In so doing, the Society is committed:

- to serving both its individual Members as a primary co-operative society, and its Corporate Members as a federal co-operative society;
- to providing within its democratic structure equal opportunities ...
- to following Co-operative Principles.

The rules of United Co-op include at rule 5(b) the statement that

... the Society is dedicated to being a successful Co-operative, serving the needs of its members, customers and employees through striving to be the premier community retailer, offering attractive membership benefits and supporting the local communities in which it trades.

These statements of purpose are important.⁴ They make it clear that the organisation has a specific purpose in carrying on its chosen trade, and such statements have real legal significance in the context of decision-making by those charged with the governance of such societies. They play a part in defining the fiduciary duties affecting those who make such decisions.

Purpose and distributions

They also play a part in the process of deciding what to do with the fruits - or profits - earned during the course of carrying on the chosen trade. In the context of a company, the unspoken purpose of providing a return to investors is fulfilled by making a payment to shareholders of an amount of money which is normally in proportion to the level of their paid up share capital.⁵ Such a payment, usually referred to as a dividend or distribution, is determined once the results for a period of trading have been determined and the

directors know the amount of profit which has been earned. From this they can make an informed decision, perhaps in accordance with a dividend policy which has been agreed by shareholders, as to how much to pay to shareholders in the form of a dividend, and how much to retain within the business, thereby increasing the value of the shareholders' equity stake in the company.

Turning to a co-operative society, however, given its broader purpose, the scope for distributions is also broader. As a matter of law, it is permitted to make only limited payments to members as a return on capital.⁶ However it is normal for a co-operative society to share its surplus with its members (and non-members⁷) in accordance with transactions which they have had with their society. In a retail society, this is on the basis of purchases from the society. In a workers co-operative, the work contribution is the relevant factor. Historically, societies with both consumer and worker members paid a dividend to both.⁸

In addition to making direct payments in proportion to trade with the society, other uses of surplus in accordance with the Co-operative Principles are common. The 5th Principle refers to the provision of education and training for members, and providing information to the general public, and is an example of this. The 7th Principle states that co-operatives work for the sustainable development of their communities through policies approved by their members. This provides the basis for substantial community work by societies, again paid for by distribution out of profits.

Societies are increasingly having regard to achieving a balance in their distributions policy to reflect the legitimate interests of their relevant participants (customers, employees and community). In its report earlier this year, the Co-operative Commission recommended that in order to meet their co-operative and social goals, societies should allocate part of their profits to a community dividend. The Commission further recommended the establishment of a Co-operative Foundation as a vehicle for channelling the community dividend into co-operative and community initiatives.

What is happening is that there is a renewed focus on what it means to be a co-operative, and the role co-operatives play in their communities. This is really sharpening the contrast between co-operatives and companies as the movement restates its core values, and customers, workers and communities begin to see and understand why a co-operative can deliver something different and better.

A key point to recognise is that it is the underlying purpose of the co-operative - its *raison d'être* or mission - which informs the decision about how profits are to be applied. But because the payment of a distribution by a co-operative is not restricted, as in a

company, to paying a return to shareholders, there is potentially a much wider scope for the sort of payments that can be made by way of distribution. It therefore becomes important to have a clear understanding as to what, as a matter of law, constitutes a distribution.

Characteristics of a distribution

Unlike an individual, a corporation (whether a company or a co-operative) is not at liberty to make payments or transfer assets at will. It is restricted by the terms of its constitution, and can only make payments which are within its powers (*intra vires*). In most cases, payments are made either directly or indirectly for the purpose of the trade - buying goods or materials, paying wages, rent, tax. Such payments are commonly made either to acquire something (such as goods or labour), or because of some legal obligation. Some payments are less directly linked, but nonetheless for the purpose of the trade. Research and development, marketing, supporting local charities, sponsorship, payments to political parties, are all payments which directors of a company might make, but they have to be able to justify them in the best interests of the company if they are to stay within their legal duties.⁹

All of these payments can broadly be characterised as "payments for the purpose of the trade". They are all expenses of the business, and therefore (subject to specific exemptions) likely to be recorded as such in the books and records of the company.

There are other payments that a company commonly makes which are not "payments for the purpose of the trade". Nothing is acquired by these payments, nor are they paid because of an underlying legal liability. These are payments made to the company's shareholders.

Such payments fall into two categories. First, there are payments by way of return of capital, that is to say repayment of capital which has been invested by the shareholder but which is no longer needed. In relation to a company, the circumstances in which such payments can be made are strictly limited to certain types of share, or to situations where the court permits a reduction of capital. These restrictions form part of the overall architecture of company law under which a company is obliged to maintain its capital. (By comparison, industrial and provident societies are not bound by the same maintenance of capital requirement, and are at liberty to repay capital to members subject to the provisions of the rules of the relevant society.¹⁰)

Second, there are those payments which are the distribution of

the profits earned in the course of trade.¹¹ In a company, such payments are made exclusively to the shareholders. In a co-operative society, as already mentioned, a wider range of payments can be made by way of distribution of the profits.

Although both of these two categories of payments can only be made with proper regard to the trading position of the corporation concerned, neither of these types of payment are payments for the purpose of the trade of the corporation. Rather they are payments made in relation to the underlying purpose or reason for the existence of the corporation. That is to say, payments of dividends to shareholders of a company are made in order to fulfil the purpose of paying a reward to investors; and distributions by co-operatives are made to fulfil their wider objectives stated in their own rules, or otherwise summarised in the ICA Statement of Co-operative Values and the Co-operative Principles.

A key feature of distributions is that they are not made pursuant to a legal obligation.¹² Indeed a corporation is unable to determine its ability to make such a payment until it has drawn its accounts for a trading period and determined whether or not a profit has been earned to enable such a payment to be made. That is not to say that there will not be commercial pressure to make payments. Companies whose shares are traded on an exchange will need to pay dividends if their share price is to be maintained. Indeed to maintain the confidence of investors, a company might even pay a dividend to shareholders if it has made a loss in its latest accounting period, providing that it has reserves from previous years' trading out of which such a payment can be made.¹³ However, there is no legal obligation to pay dividends or distribute profits, and the decision to make such payments is subject to the discretion of the corporation, either by decision of its members, or its directors if delegated to them.¹⁴

Distributions by co-operatives

Turning now to consider specifically the question of distributions by co-operative societies, it is necessary to define what payments, as a matter of law, it is possible to make by way of distribution.

The starting point for this is section 1 of the Industrial and Provident Societies Act 1965 (IPSA), which specifies that a society carrying on any industry, business or trade can be registered under IPSA if the registrar is satisfied that it is a bona fide co-operative society.⁽¹⁵⁾ The expression "bona fide co-operative" is not defined in IPSA, and the only accurate way of defining it is by reference to the societies which the Registrar of Friendly Societies has in recent

years registered. In practice however, the Registrar will register societies whose rules reflect the Co-operative Principles.

IPSA sets out in Schedule 1 those matters which must be provided for in a society's rules. Paragraph 12 in this Schedule is "the mode of application of profits of the society." A society must therefore state in its constitution, and then follow its own rules as to what it is to do with its profits.

This is the key point - that it is the rules of the society which determine what by law can be paid as a distribution. The rules in turn are subject to the review of the Registry of Friendly Societies whose statutory duty is to determine whether or not a society is a bona fide co-operative and therefore entitled to be registered and to keep its registration as an industrial and provident society registered under IPSA. For not only does the Registrar review the rules at the point of registration, but any rule amendment has to be approved by the Registrar before it takes effect.¹⁶

What this means in practice is (1) that a co-operative society is only allowed as a matter of law to pay distributions which are permitted by its rules; and (2) that what the Registrar will permit societies to register as a rule is governed by IPSA itself and the manner in which the Registry of Friendly Societies implements the Act. The Registrar has permitted a variety of types of payment by way of distribution including payments to community projects and causes, and payments to the Co-operative Party. These are all regarded as legitimate "modes of application of profits".

Historically, the Registrar has been willing to register rules which permit payments to members on the basis of transactions. The most familiar basis is that of purchase transactions from a retail society. Other transactions include sales to the society in relation to agricultural marketing co-operatives, and work contribution in worker co-operatives.¹⁷

This confirms the basic understanding that a co-operative is an association of persons whose trading relationship with their society is at the heart of and part of the purpose or reason for the existence of the society. The nature of that trading relationship can take a number of forms including the sale and purchase of goods as well as the sale (and presumably purchase) of labour.

Whilst the most familiar model today is a retail society whose members are customers (though they may also co-incidentally be employees), or a workers co-operative where employees are members, historically "co-partnership societies", where both customers and employees are members, have been a significant feature.¹⁸ A current example of such a society is Queen Eleanor Limited, whose rules expressly provide for the distribution of surplus (inter alia) to workers in proportion to their wages or salary, and to

customers in proportion to their purchases. The rules of this society further provide that all such share of profits for employees shall be credited to the recipient as share capital (subject to limits).

It is important to note that distributions are not restricted to members. There is nothing in the Industrial and Provident Societies Act which so restricts distributions, and indeed to do so would cut across a number of the Co-operative Principles. The Act requires societies to decide for themselves in their rules the "mode of application of profits" and for many years model rules have provided for the payment of distributions to non-members where the general meeting so decides.¹⁹ This covers customers who choose to bring their trade to a society who may thereby be able to share in a surplus, others who may benefit from a fund established for the purpose of education, culture or recreation (perhaps families and friends of members), or other members of the community who may benefit from the community dividend.

All employee share plans

Having established that the provision of labour is capable of being a transaction for the purposes of payment of distribution, it is appropriate to consider the opportunities for All Employee Share Schemes presented by the Finance Act 2000.

Schemes approved by the Inland Revenue under this legislation must provide for shares to be available to all employees.²⁰ Such plans are capable of being set up on the basis that the achievement of trading targets will result in an allocation of shares to employees, and that such allocation will reflect in some way the amount earned by each employee.

Following a discussion with the Registry of Friendly Societies, United Co-op has implemented rule amendments to facilitate the introduction of an All Employee Share Plan, and has included an amendment to its rule covering the distribution of surplus. That rule now permits the society to pay for the cost of shares issued under the Plan out of the society's profits,²¹ and it is therefore a lawful allocation of profits under IPSA. By agreeing to this rule amendment, the Registry of Friendly Societies has accepted that payments for shares under such a scheme amount to a valid form of profit distribution for a bona fide co-operative.

Conclusion - The Co-operative Advantage

As stated in the opening sentence, the payment of distributions by co-operative societies is an important part of the very purpose of existing as a co-operative. What distinguishes co-operatives from

companies is the fundamentally different purpose. Both organisations trade with a view to making profits, but whereas companies trade with a view to benefiting investors, co-ops trade to benefit their members and the communities in which they trade.

The Commission rightly identified the achievement of social goals as part of a virtuous circle in which the achievement of those goals provides a competitive advantage leading to commercial success, which reinforces the ability to meet the social goals. The payment of distributions is a key part of the mechanism of delivering those social goals.

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Notes

- 1 Palmer's Company Law para 9.702
- 2 See also Halsbury's Laws of England vol 24 under Industrial and Provident Societies at paragraph 1 and ff.
- 3 The phrase "not for profit" is unhelpful and inaccurate. Any corporation which is trading needs to earn profits if it is to avoid insolvency, and co-operatives strive with no less energy to be profitable than do companies.
- 4 It is more common for societies trading for the benefit of the community to state this commitment expressly. See for example the National Housing Federation's model rules for housing associations which states at rule A2: "The association is formed for the benefit of the community. Its objects shall be to carry on for the benefit of the community ... the business of providing housing ..."
- 5 See for example regulation 104 of Table A, Companies Act 1985.
- 6 This is accordance with the 3rd Co-operative Principle.
- 7 See further below.
- 8 See further below.
- 9 Unless the constitution of the company specifically permits it, the directors are not permitted, for example, simply to give money away to charity where no benefit will accrue to the company. This would be a breach of fiduciary duty. In practice, where private companies owned by philanthropic shareholders do just this, it is done by consent of the shareholders who effectively thereby waive their right to challenge the conduct of the directors.
- 10 See Snaith - Handbook of Industrial and Provident Society Law, paragraph 8.2.
- 11 A scrip dividend is of the same nature as, arguably, is the discount in a discounted rights issue.
- 12 No right of action for a dividend accrues to a shareholder until a dividend has been declared (Severn and Wye and Severn Bridge Railway (18966 1 Ch. 353).
- 13 See for example the recent dividend declared by Railtrack following the announcement of trading losses.
- 14 Where investors wish to have a guaranteed return, they invest in debt

rather than equity funding. The latter commands a higher price because of the greater risk involved.

- 15 We are not concerned in this note with the other category of society capable of registration under IPSA, namely those whose business is conducted for the benefit of the community (section 1(2)(b)).
- 16 Section 10 IPSA. This is in stark contrast to the amendment of articles of association of a company registered under the Companies Act in relation to which the Registrar of Companies has no regulatory role.
- 17 See Snaith - Handbook of Industrial and Provident Society Law chapter 8 page 22.
- 18 See Roger Jones' article in the Journal of Co-operative Studies vol. 34 no. 1 at page 43.
- 19 Rule 90 (e) in the current 11th Edition (Retail).
- 20 Finance Act 2000 paragraph 8 (1)
- 21 Rule 91 (e) (ii) now states: Dividend - subject to the discretion of the Board in paying the cost of such shares as the Board shall decide to issue under the terms of any Employee Share Scheme under Rule 19.