Co-operative Capital

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This paper identifies as controversial three aspects of a recent report on the *The Capital Finance of Co-operative and Community Benefit Societies*, published by Co-operatives UK. These aspects are the need for a clear assertion of the principle of limited return; the proposition that transferable shares are of little value without engagement with the City; and whether societies already have the necessary legal power to redeem transferable shares. These issues are of immediate practical relevance.

When I was asked by Co-operatives UK to produce a Report (Hayes, 2013) on the capital finance of co-operatives and community benefit societies (the new name for UK industrial and provident societies), it was not my intention to court controversy. On the contrary, I saw this simply as an opportunity to take a fresh look at the issue, about a decade after switching from practitioner to academic. The work was partly prompted by the removal of the £20,000 individual shareholding limit from non-withdrawable shares in societies and also by the ICA *Blueprint for a Co-operative Decade* (Mills and Davies, 2012).

Much of the Report has proved uncontentious, but there are three main areas where my ideas appear to clash with received wisdom and practice. These are the need for a clear assertion of the principle of limited return; the proposition that transferable shares are of little value without engagement with the City; and whether societies already have the necessary legal power to redeem transferable shares.

There has in recent years been a welcome resurgence in the formation of societies to fund renewable energy projects and a number of public share offers, some of which offer the prospect of attractive rates of return. The niggle is that these offers often do not fix the rate of return but simply present projections in the style of a company offer. This practice may partly be tax-driven, since the tax reliefs are drafted with companies in mind. The projections do not conflict with co-operative principle, provided that they represent the *maximum* amounts that will be paid as share interest in the relevant year, and not simply an indication of the likely return from a distribution of profits as a dividend on capital.

Nevertheless the use of such projections, even as a maximum, rather than a fixed formula provides fertile ground for dispute, as events will almost certainly not develop exactly according to plan. Furthermore, investors may well be aggrieved if shares, offered on the basis of long-term projections of a certain yield, are redeemed as soon as it becomes possible to raise replacement capital at a lower cost. Arguably it is the duty of the directors to accept, and indeed actively seek out, cheaper replacement capital if the society is not to be treated as an illegal investment vehicle. On these grounds it seems better practice to specify both the coupon, year by year if necessary, and the expected redemption date in the original offer.

Secondly, the co-operative movement is wary of the City and with good reason. One view of the relaxation of the individual shareholding limit on transferable shares might be that it is a Trojan Horse and that co-operatives should stick with withdrawable shares. However large parts of the movement, especially the worker and agricultural sectors, need permanent capital and this requires a secondary market in transferable shares. In my view, there is no substitute for engagement with conventional long-term investment institutions, such as pension funds, if permanent capital is to be raised on any scale. In particular, retail ethical investors do not in themselves provide an alternative, even if in practice they might be significant investors in conventionally listed co-operative shares. This is because ethical investment has perverse consequences for a secondary market.

A number of organisations (see Brown, 2004), both companies and societies, have made successful offers to ethical investors on concessionary terms. The concession comes at a price, that such investors are interested only in primary issues and not secondary purchases,

precisely because they want to make a difference. There is little interest among them in second-hand shares, where the proceeds of purchase go to an existing shareholder and not into the enterprise. The implication is that such investors will get fair treatment only when their shares are redeemable at nominal value. Otherwise the price of transferable shares will fall in the secondary market to their objective financial value. In cases where the issuer is immune from take-over for social reasons, there is no ultimate exit short of winding up, so that the shares can be valued only on the basis of their dividend yield, which is often zero.

Thirdly, Ian Snaith (2013) has questioned whether societies have the legal right to redeem non-withdrawable shares, short of winding up. He reasons that the common law principle of capital maintenance applies to both companies and societies; the inconsistency of withdrawable capital with case law is trumped by statutory exception. An alternative view is that society legislation protects the interests of creditors differently from company law and has more in common with partnership law modified by limited liability. Under section 57 IPSA 1965, the interests of creditors are already protected by the potential liability of members to repay any withdrawals in the event of insolvency within one year (although I suspect this is not generally understood). This is very similar to the provisions governing the repayment of capital in the modern limited liability partnership (Whittaker, 2004: 229).

Snaith considers that further legislation is necessary to clarify the legal position and recommends the extension to societies of the provisions of the Companies Acts that permit the redemption or purchase by the company of non-withdrawable share capital. This would impose a significant compliance burden in terms of legal costs, accountant's reports and declarations of solvency by directors. It would also represent an erosion of the important difference between societies, as a form of partnership between people, and companies, as corporate bodies with minds of their own. Such 'clarification' would not be helpful.

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References

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How to cite this article

Hayes, M. (2013). Co-operative capital. *Journal of Co-operative Studies, 46*(3), 43-44.