International Journal of Cooperative Law

Issue I | 2018

www.iuscooperativum.org

Practicioners' Corner

CO-OPERATIVES, THE STATE, AND MORAL HAZARD

Ian Adderley,
Senior Associate / Mutuals Team / Authorisations Division,
Financial Conduct Authority

This article explores the nature of the relationship between co-operatives and the State, written primarily from a UK perspective.

In the United Kingdom (specifically Great Britain) "co-operative" is not defined in law. Therefore, co-operatives are free to use any legal form or none at all.

The decision to adopt some kind of legal form – and in particular to become a body corporate - leads to perhaps one of the first interactions a co-operative has with the State. In Great Britain, most co-operatives choose to register under the Co-operative and Community Benefit Societies Act 2014 (2014 Act). The 2014 Act specifically enables a society to register *as* a "co-operative society".

With registration, comes legal personality and limited liability. To achieve such status a group of (at least) three people have to establish to the registering authority's satisfaction, currently the Financial Conduct Authority (FCA), that they are a "bona fide co-operative", and that their rules cover the matters required of them by the 2014 Act.

The 2014 Act is short on definition. It must be "shown to the satisfaction of the FCA" that "the society is a bona fide co-operative society"[1]. The 2014 Act goes on to rule out any society that "carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends, or bonuses on money invested or deposited with, or lent to, the society or any other person"[2].

No further definition is given. One could speculate on why the UK Parliament chose to give no further definition. It could be argued that such a vague definition allows the nature of a co-operative society to evolve over time. It could be a product of the context and time in which the provisions of the 2014 Act were written.

Prior to the commencement of the 2014 Act, the legislation under which co-operative societies were registered was known as the Industrial and Provident Societies Acts. The first of these appeared in 1852, with limited liability and corporate body status appearing in an Act of 1862, the next major revision and consolidation in 1893, and then no further consolidation until the Industrial and Provident Societies Act 1965, which remained the act of registration (albeit with amendments over time) for 49 years. Despite the first "industrial and provident" society piece of legislation appearing in 1852, it was not until an

---

[1] Section 2(2), Co-operative and Community Benefit Societies Act 2014

[2] Section 2(4) ibid

amending Act of 1939 that the word "co-operative" first appeared on the UK Statute books. The Prevention of Fraud (Investments) Act 1939 (1939 Act) was concerned with the mischief of "share pushing".

The 1939 Act made amendments affecting every legal form available in the UK. When it came to the industrial and provident society legislation, it considered that conditions of registration ought to be created, with the Registrar[3] of the time being empowered to cancel the registration of any society that failed to meet those conditions.

The 1939 Act and the debate leading up to it present a rare and interesting insight into the effect the features of a co-operative have on the State when legislating. The 1939 Act brought about a "licencing" regime for those involved in public offers of shares.

> "Clause 1 provides that on and after the appointed day, no one shall carry on the business of dealing in securities unless he is the holder of a principal's licence and that no one shall in the capacity of a servant of any such person deal in securities unless he is the holder of a representative's licence"[4]

And concluded that there should be exemptions from this requirement:

> "Industrial and provident societies…are excluded because they are otherwise regulated in the Bill—namely, in Clause 10[5]"

Clause 10 of the Bill sets out what we discussed above – the conditions of registration as a basis for registration and cancellation. It can be concluded therefore that Parliament was of the view that requiring a co-operative society to be a "bona fide co-operative", and making clear that it could not exist for the object of making profit to pay interest on shares, was sufficient regulation to justify exempting societies from licencing for the promotion of their shares.

These days we are familiar with the International Co-operative Alliance Statement of Identity, Values and Principles ("the ICA Statement"). Yet no such definition existed, in common parlance, at the time the 1939 Act was drafted. We can only speculate as to what it is about a co-operative that gave Parliament sufficient confidence to exempt them from requiring applying to other legal forms.

The clearest indication we have of the view of Parliament is from their prevention from registration as a co-operative society any society existing to pay interest on shares. It is clear that Parliament was of the view there should be some other main object, and no doubt few if any people in the co-operative movement would disagree. Still though, there was no widely accepted definition of a co-operative in place at the time. Yet, whatever the commonly held view of a co-operative was, it was implicitly incorporated into exemptions from licencing on share offers and the "bona fide co-operative" test.

---

[3] Space does not permit a full historical account of the role of the 'registrar' – the origins of which come from the Friendly Society Acts pre-dating the industrial and provident society legislation.

[4] Hansard, HL Deb 28 February 1939 vol 111 c972

[5] Ibid c973

The lack of a universally accepted definition was true too when Parliament legislated in 1965. By 2014, the position was different. We had the ICA Statement which had been recognised in international law through International Labour Organisation (ILO) Recommendation 193. However, the 2014 Act was simply a consolidating piece of legislation – it was not able to make any substantive amendments. The renaming of the legislation and the legal forms therein came from the lesser known Co-operative and Community Benefit Societies and Credit Unions Act 2010 (2010 Act), simultaneously commenced and repealed on 1 August 2014. As a "Private Members Bill"[6] it provided little room for substantive change.

This leaves us in the position we are in today: societies being able to register as "co-operative societies" subject to the satisfaction of a registering authority whose role is to establish whether the society is a "bona fide co-operative society".

Normally in the UK, where Parliament has legislated sparingly, we benefit from a rich tapestry of case law, with binding precedent to fill-in the gaps[7]. Unusually, no such case law exists in this field. At no point has a UK court made a binding judgment as to the definition of a co-operative, or as to how the legislative test should apply.

This leaves us in the position where co-operative law and the ICA Statement have developed quite separately.

What then from a legislative perspective is a "bona fide co-operative society", and how does one judge this?

This is a question the FCA asked in its 2014 consultation[8], and answered in its 2015 Finalised Guidance[9]. The FCA concluded:

> "We generally consider something to be a bona fide co-operative society where it 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."[10]

It went on to state that:

> "Reflecting the ICA Statement of Co-operative Identity, we consider it an indicator that the condition for registration is met where the society puts the values below [ICA

---

[6] A bill brought by a backbench Member of Parliament without Government time or support

[7] Leaving aside the jurisprudential debate as to whether judges make law…

[8] CP14/22 Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014 - https://www.fca.org.uk/publications/consultation-papers/cp14-22-guidance-fca's-registration-function-under-co-operative-and

[9] Pages 26-29, FG 15/12 – Guidance on the FCA's registration function under the Co-operative and Community Benefit Societies Act 2014 -

[10] Para 4,10 ibid

> Statement Values] into practice through the principles quoted below [ICA Statement Principles]."[11]

This puts the registering authority in the position of determining whether it is satisfied something is a "bona fide co-operative society" by reference to the ICA Statement.

But what does that mean in practice?

As mentioned earlier, the condition of registration is also a basis for cancelling the registration of that society where the condition is no longer met. In other words – a society can be cancelled if "it appears to the registering authority"[12]that the society is no longer a bona fide co-operative society.

Is it the role of the registering authority to regulate the activity of the co-operative society to secure compliance with the condition of registration? What if the co-operative ceases to abide by the ICA Principles?

This brings us into the topic of the line between a registering authority and a regulator. In the UK, the registering authority is just that. The overarching role of the FCA in its context as registering authority under the 2014 Act is set out in legislation:

> "The FCA must maintain arrangements designed to enable it to determine whether persons are complying with requirements imposed on them by or under [the 2014 Act]"[13]

It is worth pausing on this requirement –as much for what it does not say, as for what it does.

The requirement on the FCA is to "enable it to determine". This is not a requirement to "ensure", or "provide" for anything. It must be able to determine "whether persons are complying". This suggests ongoing compliance – both at the point of the initial registration of the society and thereafter. And finally, "with requirements imposed on them by or under…" the legislation. It is clear here that the requirements are created not by the FCA, but by the legislation.

The FCA is given no power to create rules by which societies must abide. The rules are created by legislation. It can be said that societies are regulated not by the FCA, but by the Act.

Of itself that would be fairly meaningless. This creates a role for a "registering authority". A body able to determine compliance and, should it wish, to take action where it sees non-compliance.

There is however an important distinction here still between the role of a registering authority and a regulator. For the registering authority, ultimately its actions are confined to prosecuting offences, and cancelling registration – essentially, removing the privileges the Act has provided, where those privileges have been abused.

---

[11] Para 4.12 ibid

[12] Section 5(5) Co-operative and Community Benefit Societies Act 2014

[13] Para 5, Schedule 1, The Financial Services Act 2012 (Mutual Societies) Order 2013

This distinction may be easily understood by some. But how widely is it understood by the co-operative societies, and more importantly, by their members and the public at large?

Today, corporate body status and limited liability seem fairly uncontroversial. Looking back at its introduction though, we are reminded that its passage through Parliament was not without opposition. That opposition, in part, comes in the form of moral hazard. When you limit the liability of some, it is inevitably at the expense of someone else. In the case of the firm, the risk is that third parties, i.e. creditors, are exposed to undue risk with limited redress when dealing with someone whose own liability is limited.

Balancing out this risk, the privileges of limited liability come with reporting requirements – such as the requirement to submit annual returns and accounts to a registering authority to be made available to the public, enabling the creditor to reduce the risk of trading with someone with limited liability.

This is true for a co-operative society. For a co-operative society, however, there is an added dimension in the form of what is expected from co-operative governance, as reflected in the ICA Statement.

To what extent do the public rely on these features? The 1939 Act shows us that Parliament has, at least in part, relied on the nature of a bona fide co-operative to exempt it from regulations designed to protect the public from "share pushing". Are the public aware of these exemptions – or do they rely on the fact the society is "registered" to give them equal confidence in the society's business?

What expectations do members have of their co-operative? For example, members of a co-operative expect their society to be run democratically. Referring to the rules of their society members may look and find that it should be run on the basis of 'one-member-one-vote'. Or they may find that their co-operative has rules requiring the accumulation of indivisible reserves, with dissolution clauses preventing distribution to members on a solvent dissolution – instead directing funds to some other common ownership entity.

What then, do members do, if they find these rules are not being adhered to?

As a scenario – you have two rival factions in a society. One faction is "in power", the other trying to gain power. The first faction decides to ignore certain aspects of the co-operative's rules to maintain power; the second faction understandably objects to this.

In some instances, those breaching the rules will be in the minority and will succumb to a decision made by the majority to remove them from office or to reverse any policies or practices they have put in place. That is fine where that works. But what happens where it fails?

It is natural that members may then look to the registering authority. After all, it is their job to make sure the co-operative is behaving properly, isn't it?

This scenario brings us to the core of the issue. Stepping in to force a co-operative society to take a particular course of action in relation to a particular decision is the act of a regulator, not a registering authority. The registering authority cannot order specific performance. This does not mean it is powerless;

quite the opposite. The registering authority has a big stick at hand – the threat of cancellation of registration.

However, the wielding of that stick is likely to all too often be the last thing those concerned members want to see happen. Here we see a gap between perception and reality. A gap between what members think a registering authority ought to be able to do, and what in reality it is able to do.

It is not clear whether members take undue risk in these situations, in the sense that they fail (whether due to lack of resources, know-how, energy or inclination) to step-in to take action to prevent a situation arising, because they think there is ultimately a registering authority who can sort it for them. Evidence would be required to support this - but it is not beyond the realms of possibility to imagine at least some instances where this is the case.

While the registering authority may not be able to order specific performance in this instance, is there another arm of the State that can help? It is possible to refer these sorts of matters to the court. There have been numerous unreported cases where County Courts in England have settled disputes such as these – taking a view on the application of the rules and ordering a course of action to be followed.

But what happens where existing precedent hinders rather than helps?

In the scenario above, we had two rival groups of members. It is a classic dispute, of the sort the courts are more than familiar with, and a sort not unique to co-operatives.

Let us take a different scenario[14]. What if there were a co-operative society established many decades ago. In its rules, it established that it was a common ownership co-operative. A co-operative where the members would never benefit from surplus funds on solvent dissolution (above the return of their own share capital). Members may have even gone one step further and stipulated that these rules can never be changed. This is in keeping with ICAPrinciple 3 –the build-up of an indivisible reserve. And it is in keeping with the view that co-operative members are stewards of the enterprise, for successive generations.

Down the line one particular set of members decide that they want to change the rules. They want to change the dissolution rules to enable distribution of assets to members on solvent dissolution. In English law, it is likely that the *Duomatic principle*[15] applies. This principle, originating from company law, means that unanimous consent of the members can override any provision in the governing documents. Therefore, the current group of members could unanimously agree to change the rules of the co-operative to enable them to benefit from solvent dissolution[16].

The registering authority would be presented with a rule amendment that it can only reject if the amendment is “contrary to the Act’. In this instance, the registering authority, given the current legislative

---

[14] For the purpose of making a point succinctly, the nuance that would ordinarily be present in any such situation has been omitted

[15]Re Duomatic Ltd [1969] 2 Ch 365

[16] It is yet to be seen whether the courts would uphold this precedent in this sort of context – but in the absence of any nuancing of the established precedent, we must assume this would be permissible.

position, would have been able to offer little protection to those previous generations of members who have helped the co-operative accumulate its capital. Perhaps a regulator, given broader powers through legislation reflecting a detailed understanding of the co-operative movement, could have been empowered to do more.

This begs another question – why does case law not better cater for the position of co-operatives? The simple answer, most probably, is because co-operatives have rarely litigated points of law (as opposed to having recourse to the courts for determination of disputes). They have rarely engaged with the legal system to test out different situations. It cannot be taken as read that a court would not distinguish the *Duomatic principle* in the case of a common ownership entity.

Likewise, there are other cases – such as *Trevor v Whitworth*[17], which has previously created debate on whether a co-operative can have redeemable shares (on the basis that it, in effect, ruled that a company cannot buy back its own shares). It is not inconceivable here that a court would understand that *Trevor v Whitworth* arose from a company with fixed capital, whereas the co-operative society has never had its number of shares fixed in the same way, and accordingly distinguish the case. After all, on rare occasions where co-operatives have litigated points of law, they have been successful[18].

There is inherent risk in litigating a point of law – you could lose and have a definitive answer against your favour. That risk is not unique to co-operatives. But, does the crystallisation of that risk pose a greater threat to co-operatives from the perspective of autonomy and independence; or more broadly, depending on the point being litigated, to any of the other ICA Principles?

This addresses what role the State *could* have, and leads us into consideration of what role the State *should* have in these matters when considered from the perspective of the ICA Statement. Principle 4 provides that:

> "Co-operatives are autonomous, self-help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy."

Whether a co-operative can be truly autonomous is a bigger question than space permits, but it is worth exploring autonomy briefly in this context of what the role of the State should be in co-operative matters. Regulation by the State is present to varying degrees in every facet of a capitalist society. Regulation impacts autonomy. For example, regulation enabling property ownership – which on the one hands provides a framework for ownership, on the other creates conditions for those owners (such as the requirement to register that property, or seek permission for adaptations to it). The ICA Guidance Notes to the Co-operative Principles explore the relationship between the State and autonomyin more detail – concluding on the relationship between co-operative and State:

---

[17]Trevor v Whitworth (1887) LR 12 App Cas 409

[18] Co-operative Group (CWS) Ltd v Stansell Ltd [2006] WWCA Civ 538

> "engaging with government on legal and policy matters does not however mean compromising the autonomy and independence of co-operatives and the ability of members to democratically manage their organisations without government interference. This 4th Principle of Autonomy and Independence means that members of co-operatives are entitled to make decisions about their co-operative without undue influence from government beyond a wider policy environment that impacts equally on other forms of economic organisation."[19]

When it comes to the formation of co-operatives – in the UK at least – there appears to be a sliding scale of State involvement. A co-operative may wish to simply be a loose group of individuals, or maybe an unincorporated association, thus avoiding limited liability and body corporate status. With that, comes more freedom, the absence of reporting requirements.

But that would leave co-operatives in a disadvantageous position compared to other businesses. A co-operative could choose to become a company or limited liability partnership. Free from the requirement to have a registering authority determine whether it is or is not a co-operative. That does however leave a co-operative with nothing in place, legislatively, to set in stone that it is in fact a co-operative and can lose the privileges of registration by ceasing to act like one.

Or it could choose to be a co-operative society, with the abovementioned requirements in place. Legislation could go even further than it has and put in place a statutory asset lock, providing a solution to the scenario descried earlier in which the society decides to use its assets in a way not permitted by the original rules.

As we slide along the scale of State involvement, at each moment we risk reducing the autonomy of the co-operative. Has there been a trade-off? Is it the case that co-operatives are willing to sacrifice some autonomy, if by doing so they can more deeply embed other Values and Principles (such as legislative provisions ensuring democratic member control)? And if so, where should the line be drawn?

And, on the part of the State, to what extent can and should it take into account the unique features of a co-operative society when putting in place regulations more generally as explored earlier in the context of the 1939 Act?

This article does not provide the answers to those questions. But instead it is hoped some focus has been directed toward the delicate balance that exists between co-operatives and the State, and the impact one's understanding (or misunderstanding) of that relationship can have.

---

[19] Page 50https://ica.coop/sites/default/files/basic-page-attachments/guidance-notes-en-221700169.pdf

International Journal of Cooperative Law

The International Journal of Cooperative Law (IJCL) is a peer-reviewed, open access online journal, founded by Ius Cooperativum in 2018. It is the first international journal in the field of cooperative law. It aspires to become a venue for lawyers, legal scholars and other persons interested in the topics and challenges that the discipline of cooperative law faces.

The content of the journal is under the Creative Commons license 3.0, which allows free sharing and remixing of the text under the condition of attributing the source.