REFORMS FOR COOPERATIVES, MUTUALS AND MEMBER-OWNED FIRMS ROUNDTABLE –31 MAY 2017

SUBMISSION – KEY POINTS

Ann Apps, Lecturer, Newcastle Law School, University of Newcastle

Contents

THE ACADEMIC ARGUMENT

1. The need for diversity of business models

- The key question here is not whether the federal government wishes to see the co-operative and mutual sectors thrive – *but whether it wishes to see them survive*.

- This may sound extreme – but this submission argues that *the increasing proceduralisation of company law* and the law relating to financial services and markets – will inevitably leading to the *homogenisation of business (governance) models* in Australia.
- This is contrary to the trend in other jurisdictions including the UK, US and Canada where we have seen the legislative recognition of new, diverse and innovative business models.
- I have previously argued that there is room for the legal recognition of a distinct hybrid co-operative company within the *Corporations Act* framework. The express acknowledgement of a 'co-operative company' as a distinct company type may lift the profile of the co-operative sector and provide a solution for those successful producer co-operatives who seek better access to capital but do not wish to relinquish producer-member control.
- A similar argument applies here to the express recognition of the 'mutual' as distinct type of company with an alternative governance model to the investor shareholder model.

2. The impact of the proceduralisation of company law.

If the *Corporations Act* was purely an enabling piece of legislation, this lack of express definition and legal identity may not have had such an adverse impact on the co-operative and mutual sector. So long as co-operatives and mutuals maintained an internal governance structure that was consistent with a member owned or mutual business, arguably it did not matter what legal vehicle they chose for incorporation and registration.

However, the *Corporations* Act is more than a piece of enabling legislation for various types of business association. The legislation is mainly concerned with regulatory control of the corporate and financial services markets.

The legislation's concern with regulatory control is a justifiable response to the concentration of power at the top end of the market and some spectacular examples of the consequences and impact of corporate greed and mismanagement in the past few decades. There is no suggestion here that the co-operative and mutual sector is immune from corporate misbehaviour or mismanagement. **That is not the point of this argument**. Regulatory control of these markets is not only punitive – it is also responsive and seeks to encourage a particular type of outcome i.e. consumer confidence in free and transparent markets.

The problem for the co-operative and mutual *sector* ***is that most regulatory controls are tailored to remedy or respond to the behaviour of a particular type of governance structure*** – i.e. one where the key stakeholders are shareholders who are seeking to maximise their return on investment.

Mutuals and co-operatives have a different type of governance structure, their key stakeholders are members and their primary objective is to seek maximum value from their transactional relationship (as customers or suppliers) with the business.

Professor Ross Grantham, in his article "The Proceduralisation of Company Law",[1] argues that:

> *"the Corporations Act,2001 has moved from an essentially private law substantive rights model - to a model that seeks to regulate a company through the prescription of processes and practices by which corporate decisions might be made and by which the procedural correctness of those decisions is assured."*

Regulatory Guide 147 provides an example of a prescribed process. It sets out in details how ASIC will use its exemption process when dealing with mutuals who seek to change their constitution or issue shares that might impact on its 'mutuality'.

Part 5 Schedule 4 is process driven. The power to determine mutuality here is given to ASIC and not the Court – and the application of Regulatory Guide 147 to the application of Schedule 4 Part 5 is negative in its approach. ***It assumes that a financial institution is seeking to demutualise*** and the disclosure requirements under this part are aimed at protecting members by ensuring a full disclosure. **It does not help a financial institution that is keen to retain its mutuality and member driven focus – but need to access additional capital to meet its underlying goals.**

While the intention behind the guide it to protect members of mutuals by ensuring that it complies with the comprehensive disclosure processes set out in Part 5 of Schedule 4 of the Act. **Part 5 Schedule 4 effectively makes this detailed prescription in a legal vacuum as a 'mutual' is not defined in the Corporations Act**.

[1] (2015) 43 Federal Law Review 233

For example – a *company may trigger the disclosure requirements in Part 5 whether they are intending to demutualise or not.*

The consequences of this vacuum need to be considered in the context of the proceduralised approach to corporate law and governance. The argument is that this approach is primarily concerned with the decision making process itself, where the outcomes of that process are of little or no concern.

This approach is also manifested in Schedule 4 Part 5- where approach is legitimise a decision to demutualise by requiring the decision to be approved by current members at general meeting. The approach justifies any lack of impartiality on the part of the ***directors by putting current members*** in the role of supervising regulators who **may be entitled to a windfall gain from past members**.[2]

3. The argument for a 'legal identity' for mutuals.

- The argument for a legal definition of the 'mutual' business model in the C*orporations Act* is an argument for the recognition of its legal identity.
- The law plays an important role in defining the key identity features of the various types of business model.
- An accepted legal definition helps the courts make decisions regarding how regulation should be applied in particular circumstances. (Noting in this case that such a definition primarily for the purpose of allowing mutuals to use a tailored security interest to access equity capital).
- A legal definition will also assist those who seek to defend or promote the model as a competitive alternative to investor ownership. (e.g. how does a mutual defend itself to ASIC when it is seeking to raise capital and not invoke the demutualisation regime in Part 5 Schedule 4?).
- An example of the anomalies caused by the lack of legal definition include the fact that a company "that is not a mutual but calls itself a mutual, may breach s12DA of the ASIC Act for engaging is misleading and deceptive conduct."
- If it is understood that a mutual has a distinct type of legal identity, it is much easier to understand and justify **the need for a specific and diverse treatment of the issue of securities for raising capital.**
- "The principle of equality requires that similar situations be treated in a similar way, while different situations must be treated in different ways."[3]

THE NEED FOR A TAILORED INSTRUMENT TO RAISE EQUITY CAPITAL

The **current regime is a powerful disincentive for any mutual** to attempt a shift from its current structure to permit equity capital raising (whether from members or external investors). This is at **least partly due to the lack of any legal definition of a mutual**. Such a definition may help to safeguard a business that wishes to restructure to raise equity capital (whether internally or externally) without the threat of demutualisation.[4]

A**ll mutuals are at a disadvantage when it comes to capital instruments available for capital raising (beyond member applications**). Most mutuals are structured as companies limited by

[2] Grantham at 241.
[3] Antonio Fici, Fici A, 'Co-operative identity and the Law', European Business Law Review, 24(1), 37 ; pp 1-7 http://socialcapitalgateway.eu/sites/euricse.eu/files/db_uploads/documents/1329215368_n1962.pdf
[4] This is so, despite the fact that the regime acknowledges that such an issue will be acceptable so long as it does not defeat the dominant purpose of the mutual. (RG147.51 and 147.52)

guarantee and are unable to issue shares to raise capital. These companies may only access member reserves and debt to finance expansion or growth.

Some mutuals are structured as companies limited by shares and guarantee – however these have also shown a reluctance to issue share capital, despite their capacity to do so, presumably due to the uncertainty caused by the application of Part 5 Schedule 4.

Finally, even mutuals that are structures as companies limited by shares, may be reluctant to seek equity beyond their member base due to the application of Part 5 Schedule 4.

If the mutual is an ADI, this creates a further disadvantage. It means that its access to regulatory tier 1 capital is limited to it capital reserves. While these reserves may be adequate for 'business as usual', it places the mutual at a significant disadvantage when it comes to growth and expansion.

Creating an especially tailored security instrument –that is only available to mutuals, will require the insertion of a legal definition of a 'mutual' in the Corporations Act.

1. A specific instrument may have a number of advantages for the mutual sector:
   - It can be tailored to protect the company's dominant 'mutual' purpose – by having capped returns out of current profits and no voting rights (Other than class rights under Pt2F.2)
   - It can qualify as regulatory tier one capital if it is also non-redeemable.
   - If it is specifically tailored and named (e.g. as "Mutual Capital Instrument') it may confer some confidence in members that it will not inevitably lead to demutualisation.
   - If it is successful - it might have appeal in a special or boutique market – for 'philosophical' or patient capital.[5]

DEFINING A 'MUTUAL"

A general definition

- **The dominant purpose of the mutual company is to pursue activities that provide economic and/or social benefits to members in return for their transactional relationship (other than as investor) with the company.**

(Note: Member economic benefits may include the return of surpluses in the form of mutual pricing, reduction of premiums, or the provision of other membership services in priority to non- member shareholders. Social benefits may include activities like community grants, sponsorship and financial support of initiatives that may not directly benefit the member, but will be beneficial to their community).

- The approach taken in ASIC Regulatory Guide 147 is informative. It acknowledges that the reference to 'purpose' in Clause 4 of Part 5 Schedule 4 should be taken to mean the ***dominant purpose*** **of the company that will determine its mutual status**. (RG 147.48)
- The RG147 notes that it will not be fatal to the company's status as a mutual if it provides a return to shareholders. However, *that purpose must be limited and must not be the dominant purpose* of the company. (RG147.51)

[5] See e.g. Bruno Roelants, "Capital Building in Industrial and Service Co-operatives". The capital conundrum for co-operatives,(2016) ICA, Brussels, Belgium: International Co-operative Alliance. http://ica.coop/sites/default/files/ICA%20The%20Capital%20Conundrum%20for%20Co-operatives%20EN.pdf

- RG 147 also accepts that the issue of investor shares need <u>not</u> to be limited to people who are also members of the mutual – this is because *if those shares have strictly limited economic rights (including no rights to accumulated surpluses and no voting rights)*, the holding of shares by non-members will <u>not</u> be fatal to the company's mutual structure.(RG147.52)

The guide proposes that there are two tests that need to be applied to determine the mutual status of the company and I have used these tests as the basis for a definition of a 'mutual' that might be included in the Corporations Act, 2001 (Cth)

1. The Economic Relationship Test.

- If the company is wound up, only members are allowed to share in any undistributed surplus (subject to disinterested distribution to a like institution or charity).

(Note the issue here relating to the rights of former members. There is an argument that former members of mutual companies should have a right to be given notional entitlements to surplus assets of the company (cf Co-operatives National Law s168). These entitlements would crystallise within a (2- year) period on demutualisation, takeover by a non-mutual company or liquidation. The value of the right could be based on length of membership etc.).

- **The economic rights of investors are limited to receiving a capped dividend payable only out of that year's profits.**

(*This is not consistent with s245T and it may require some tweaking to allow flexibility – e.g. by distinguishing between member reserve funds and capital growth funds, but not necessarily confined to profits in that particular financial year?)*

2. The Governance Relationship Test
   - Only members can participate in the governance of a mutual company
   - Members must have the right to participate in the governance of the company on equal footing with other members.

   (Note that RG147.63 recognises that some systems of proportional representation are consistent with mutuality).

3. Other suggestions
   - Membership and voting qualifications must be reasonable and not unfairly discriminatory to any member or class of member.

The following additional recommendations for reform are taken directly from the paper "The Principles of Mutuality – What Status do they have at law', author unknown, but available at http://www.mag.org.au/

Related amendments to the preserve 'mutual governance'

- **Directors duties**

  Justice Santow in *Re NRMA Ltd and NRMA Insurance Ltd* (2000) 33 ACSR 595 reviewed authorities in Australia and overseas and concluded ***that there are no cases that suggest that the duties of directors of a mutual company are any different to directors of non-mutual companies.***

Directors have a duty at general law and under s181 of the Corporations Act to act "in good faith and in the best interests of the company." Australian case law recognises that the best interests of the company are the best interests of its members as a whole. However, there remains some controversy over whether directors are entitled (or required) to look to the long-term viability of the company as a commercial entity and not just at the short-term benefit to current shareholders. E.g. where there is a threat of a hostile takeover, see *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 15 ACLV 230.

There may be an issue for directors of mutual companies where there is a conflict between the interests of non-member investors (whose interest is the maximisation of returns on shares) and members (whose interest is in the maximisation of member value by improved services or lower prices).

- **To ensure that the governance of a mutual company retains it mutual character – especially where shares are issued to non-members, director's *duties should be tailored to expressly provide that the 'best interests' mutual company is to promote the 'mutual' purpose of the company.***

  This would mean that the 'best interest of the company' is to give effect to its dominant purpose of maximising member value. This would encourage decision making that would increase the value of membership and facilitate member involvement in the organisation.

  (Note that the business judgement rule in s192(2) of the *Co-operatives National Law* (CNL) provides that in determining whether the decision of a directors is in good faith and for a proper purpose , the application of the co-operative principles are relevant.

  - **This could be supplemented by an amendment or addition to section 300B of the Corporations Act to include a requirement for the board to report annually to members on the policies or activities pursued by the company, which have added value to membership and encouraged member involvement.**

There is also a need for the development of standards to assist independent experts to value the economic entitlements of mutual members –

- These standards could assist independent experts to quantify the value of membership rights, including loss of democratic control in the organisation on a demutualisation. The standard could also provide for the valuation of the current services provided to members in their capacity as members and the value of services that are to be provide to members as customers of the demutualised organisation. This information would be provided to members as part of the demutualisation documentation.

- In addition, the standard could require the independent expert to review similar demutualisations and report on the effects which those demutualisations have had on the provision and cost of services to members. As part of this review, a valuation of shares received by each member should be undertaken to determine whether the shares reflect adequate compensation to the member, for any variation in the provision and cost of post-demutualisation services received by a member.