KEY LEGAL ISSUES FOR CO-OPERATIVES IN AUSTRALIA

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This submission outlines a number of legal issues faced by the co-operative model in Australia. The main issues are summarised here:

- There is a general lack of understanding of the key legal features of the co-operative model and the importance of protecting the legal distinction between the co-operative and the company models. However there is a case for diversity of business models including the separate legal recognition of a 'hybrid' co-operative company under the *Corporations Act* 2001 (Cth).
- A 'pure' co-operative allocates control rights to active members (members who participate in the business as customers or suppliers) on the basis of one member – one vote. However this model sacrifices the ability to access external capital for democracy. These models find it difficult to survive in a regulatory system that preferences the dominant company model and they need laws that properly accommodate their difference especially taxation laws, accounting standards and auditing and reporting requirements.
- In Australia co-operative growth and promotion is hindered by the constitutional restriction on the Commonwealth's law making powers in relation to the 'formation' of corporations (including both companies and co-operatives). While the company model has flourished in the federal jurisdiction, the co-operative has been left behind in the state system. Consequently the model has been largely dismissed by law and policy makers as an 'archaic' business model with little relevance in the modern market. In the state system the co-operative faces problems with inconsistencies between different co-operative laws and the barriers to formation inherent in duplicative and prescriptive administrative regimes. Although the recently introduced *Co-operative National Law* in NSW, Vic and SA seeks to address the issue of uniformity, it is another attempt at co-operative federalism which has yet to succeed in achieving its goals. Even if a degree of uniformity is eventually achieved, it has proven to be almost impossible to maintain under this sort of regulatory regime.

DIVERSITY OF BUSINESS MODELS

- In the last half century, law and policy makers have prioritised business laws that have preferenced the dominant company model.
- This has contributed to the gradual disappearance of diverse organisational types e.g. sole traders, partnerships, co-operatives - which have tended to 'morph' into the company form.

THIS LACK OF DIVERSITY IN BUSINESS MODELS HAS HAD NEGATIVE CONSEQUENCES, NOT ONLY FOR MARKETS, BUT ALSO FOR COMMUNITIES.

- Joseph Stiglitz, former Chief Economist at the World and Nobel prize winner acknowledged this problem:

  > "We [USA and Western governments] have focused too long on one particular model, the profit maximizing firm, and in particular a variant of that model, the unfettered market. We have seen that that model does not work, and it is clear that we need alternative models. We also need to do more to acknowledge the contribution that these alternative forms of organization are making to our society…, the contribution is not just a contribution to GDP, but a contribution to satisfaction."[1]

- As Henry (2012) has identified, one of the key challenges for modern co-operative lawyers is to convince law and policy makers that the legal distinction between co-operative and company enterprise types should be maintained.[2]
- In a nutshell, co-operatives have the potential to reduce the growing welfare burden faced by the state, particularly in regional Australia. To do this they need legal frameworks that are accessible to start-ups, flexible and easy to use with minimal regulatory intervention for small businesses, together with a taxation and regulatory regime that will incentivise the production of quasi 'public goods' (childcare, education, health services, sustainable energy solutions etc.) by private businesses. At the big end of town, co-operatives need some flexibility to allow them to access external capital. They also need appropriate reporting and auditing requirements so that their contribution to Australian society is appropriately measured and recognised.

A REGULATORY SOLUTION IS THE LEGAL RECOGNITION OF THE HYBRID 'CO-OPERATIVE COMPANY' AS A DISTINCT TYPE OF COMPANY UNDER THE *CORPORATIONS ACT* 2001 (CTH).

- This new business model will go some way towards resolving some of the regulatory issues faced by co-operatives in Australia. Although some co-operatives already use the company as the legal vehicle for a co-operative business (e.g. Murray Goulburn, Namoi Cotton, Almondco) these co-operatives rely on their internal rules to determine their co-operative character. These businesses must also rely heavily on strong member and management commitment to straddle two different business models with competing goals and objectives. Significantly, it is mainly the larger agricultural co-operative that have adopted the company or 'hybrid' model, to access the efficiencies of the federal jurisdiction.

ONCE IDENTIFIED AS COMPANIES, THEY BECOME INVISIBLE AS CO-OPERATIVES AND THEIR CONTRIBUTION TO THE SURVIVAL OF LOCAL BUSINESSES AND REGIONAL ECONOMIES IS UNNOTICED BY LAW AND POLICY MAKERS AS BEING A CONSEQUENCE OF THEIR CO-OPERATIVE NATURE.

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[1] D. Joseph Stiglitz, 'Moving Beyond Market Fundamentalism To A More Balanced Economy' (2009) 80(3) *Annals of Public and Cooperative Economics* 345, 359

[2] Hagen Henry, 'Guidelines for cooperative legislation' (International Labour Office, 2012), 16. Henry refers to the standardisation of enterprise types to the company form as a process of 'isomorphism"; ibid, 14.

- The legal recognition of a distinct hybrid co-operative company with regulatory protection of some of its key co-operative features will raise the profile of co-operatives in the federal corporate jurisdiction and contribute to co-operative growth and development. Growth in the co-operative sector can only have positive outcomes for the Australian economy and local communities.

ACTIVE MEMBERSHIP

- A co-operative is by definition a member-owned business. Members are required to have a trading relationship with a co-operative. [3] Apart from supplying initial capital (the price of membership) the business model requires that they must also provide an input such as labour or raw materials, or they are its customers. This means that members are always active participants in the business of the co-operative.

THE ACTIVE MEMBERSHIP REQUIREMENT IS AT THE CORE OF THE LEGAL IDENTITY OF THE CO-OPERATIVE AND HAS SIGNIFICANT LEGAL CONSEQUENCES FOR THE MODEL.

- In a 'pure' co-operative, control rights are attached to *membership* and not shares. This means that the co-operative is inherently a democratic model – reflected in the *Co-operatives (Adoption of National Law) Act,* 2012 (NSW) (CNL) by the one member-one vote rule. [4]
- While it is possible for the co-operative to issue certain types of shares and other securities to access capital from non-members, [5] the co-operative must carefully protect the control rights of its active members if it is to retain its co-operative character.
- This places the model at a considerable disadvantage when a growing business requires access to external sources of capital.

THE CO-OPERATIVE DILEMMA IS THE CHOICE BETWEEN DEMOCRACY AND EXTERNAL CAPITAL. IN A 'PURE' CO-OPERATIVE MODEL MANAGEMENT MUST RELY HEAVILY ON MEMBERSHIP CAPITAL TO FUND EXPANSION.

TAXATION ISSUES AND INTER-GENERATIONAL ASSET LOCK

- Co-operatives whether registered under state co-operatives legislation or as companies under the Corporations Act, 2001 (Cth) may be able to rely on alternative tax rules under Division 9 of the *Income Tax Assessment Act* 1936 (Cth) (ITAA).
- To be eligible the co-operative must meet certain criteria set out in s 117 ITAA. The restrictions include a limit on the number of shares held by any one shareholder and a prohibition on listing securities on the stock exchange. It must also transact at least 90% of its business with the co-

[3] *Co-operatives (Adoption of National Law) Act, 2012 (NSW)* Appendix - Co-operatives National Law, s125.
[4] *CNL (NSW)*, s.228 (2). However s.228 (3) provides that the rules may provide for a member to have up to 5 votes in a general meeting. Section 228 (4) allows the rules to provide that the Chairman has a second vote at board or general meetings.
[5] *CNL* (NSW), s 349. While the CNL recognises the Co-operative Capital Unit (CCU), this type of security is mainly used for internal funding and does not have a recognised profile on the quoted securities market.

operative.[6] The eligibility criteria mean that the exemptions apply mainly to agricultural producer and marketing co-operatives.

- If eligible the co-operative is entitled to a tax deduction for patronage rebates, bonuses or dividends on shares paid to members based on business transacted with the co-operative.[7] Some agricultural producer co-operatives may also be entitled to deductions for capital repayments on certain government loans.[8]
- Distributing co-operatives that do not meet any of the exemption classifications are taxed as companies.
- Recommendations to remove the 'special' tax treatment of co-operatives under Division 9 have been made on several occasions.[9] The objections are based firstly on the complexity of applying the provisions i.e. it applies only to some types of co-operatives and only in certain circumstances that may vary from one financial year to the next.

THIS OBJECTION RELATING TO THE COMPLEXITY OF THE RULES IS WELL FOUNDED. THE TAX EXEMPTION WILL ONLY APPLY IN A FINANCIAL YEAR WHERE THE 'BUSINESS' AND 'OWNERSHIP' REQUIREMENTS ARE MET.

- For example if Almondco required 1m tonnes of almonds to meets its obligations under existing contracts, and due to climate issues member suppliers were unable to supply the required amount so that Almondco was forced to purchase 120,000 tones to make up the shortfall, they would lose the benefit of deduction of any distributions to members in that financial year (the 'business test'). The co-operative must also monitor the level of 'dry' shareholders in a financial year. If due to the retirement or death of active members during the year, the value of shares held by active members is less than 90% the co-operative will lose the deduction.

ANY OBJECTION TO THE PROVISIONS TO THE 'SPECIAL' TAX TREATMENT OF CO-OPERATIVES IN DIVISION 9 OF THE ITAA ON THE GROUNDS THAT THEY PREFERENCE CO-OPERATIVES OVER OTHER ENTITY TYPES IS NOT WELL FOUNDED AND FAILS TO GRASP THE ESSENTIAL DIFFERENCE BETWEEN 'SURPLUS' AND 'PROFIT'.

- A co-operative does not seek to make a profit at the expense of its members. If a co-operative makes a surplus as a result of transacting with its members, it should return the surplus to members (by way of dividend, bonus or rebate). Surplus should not be treated as taxable income in the hands of the co-operative.
- Any recognition by the taxation system of the value generated by co-operatives for local communities should also be protected for the benefit of future generations. The pressure to

[6] *Income Tax Assessment Act* 1936 (Cth) (ITAA),s 118.
[7] *ITAA*, s 120.
[8] *ITAA*, s120.
[9] J T Ralph, 'A Platform for Consultation: Discussion Paper 2 - Building on a strong foundation' (1999) mentions recommendations to repeal or revise s118 1932-34 Royal Commission on Taxation, and by the 1950-54 Commonwealth Committee on Taxation, The Government sought to repeal the provision in the 1996-97 Budget but the legislation was blocked in the Senate, Ch 23, 514. A strong response from the co-operative sector to the revisions suggested in the Ralph Review resulted in their abandonment in the lead up to the 2001 Federal election, Gary Lewis, 'When government comes in the door, co-operation goes out the window - Recent Eevents in NSW Co-operatives' History.' (Paper presented at the International Congress of Historical Sciences, Co-operatives Roundtable, Oslo, 2000).

demutualise a co-operative often comes from managers who see a short term financial opportunity in exploiting the co-operative's capital reserves. However those assets have often been built over many generations and in many countries are 'locked in' by law to protect future generations. The idea of 'disinterested distribution' upon dissolution of a co-operative requires that all residual assets (after payment of debts and reimbursement of paid –up capital to members) may only be distributed to other co-operatives or a national co-operative fund set-up for this purpose.

- The CNL does not mandate 'disinterested dissolution' and its application may be inequitable in some circumstances.

HOWEVER THERE IS A CASE FOR LEGISLATIVE PRESCRIPTION OF THE COMPULSORY DESTINATION OF PART OF THE RESIDUAL CAPITAL ON DISSOLUTION TO A NATIONAL CO-OPERATIVE FUND. THIS WILL HELP TO DETER OPPORTUNISM ON THE PART OF THOSE SEEKING DEMUTUALISATION FOR SHORT TERM GAIN AND PROTECT THE LONG TERM CONTRIBUTION OF COMMUNITIES TO CO-OPERATIVE SUCCESS.

CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY

THE PRIORITISATION OF MEMBER-VALUE OVER PROFIT IS A KEY TO THE RESILIENCE AND SUSTAINABILITY OF THE CO-OPERATIVE MODEL.

- Instead of being required to maximise profit at the expense of other inputs such as labour, the co-operative manager's task is to maximise the 'value' of membership, this allows the manager to balance financial goals of members (e.g. surplus) with non-financial goals of members(e.g. customer service, environmentally sustainable production methods, ethically sourced goods etc.). The co-operative is a dual output model producing both financial and social returns to its members.

THE OWNER-MEMBER NATURE OF THE CO-OPERATIVE MEANS THAT CO-OPERATIVE GOVERNANCE IS ACHIEVED IN A FUNDAMENTALLY DIFFERENT WAY TO CORPORATE GOVERNANCE IN AN INVESTOR OWNED COMPANY.

- The CNL requires that the majority of the directors on a co-operative board must also be 'active' members of the co-operative.[10] In contrast to company directors, the issue of board members preferring their own interests to the best interest of their members is less likely to be a problem because their interests are closely aligned and are not solely concerned with profit. The effectiveness of co-operative governance has been well demonstrated by the resilience and longevity of many of the larger producer co-operatives in Australia.[11]
- The CNL includes directors' duties framed in almost identical terms to the directors' duties in the Corporations Act.[12] Specific reference is made in the business judgement rule to the

[10] *CNL (NSW)*, s. 174
[11] Murray Goulburn began as a co-operative society in 1950; Norco was established as a co-operative in 1885; CBH was established in Western Australia in 1933; In South Australia, Almondco Australia was established as a producer's co-operative in South Australia in 1944.
[12] *CNL* (NSW) ss 192 – 196.

relevance of the co-operative principles.[13] The Act also provides that in interpreting any of its provisions, an interpretation which would promote the co-operative principles is preferred. However this does not address the problem that directors and managers face if required to defend a business decision which preferences social output (e.g. ethically sourced raw materials or better employment conditions for workers) at the expense of financial output.

DIRECTORS AND EXECUTIVE MANAGERS WILL BE BETTER PLACED NOT ONLY TO DEFEND THEIR BUSINESS DECISIONS BUT ALSO TO COMMUNICATE THEIR ADVANTAGE TO MEMBERS AND POTENTIAL MEMBERS OF THE BUSINESS IF APPROPRIATE REPORTING AND AUDITING REQUIREMENTS ARE EMBEDDED IN THE REGULATORY FRAMEWORK

- Significantly, the production of social goods and the achievement of corporate social responsibility goals are an internal cost for co-operatives, and so *must* be prioritised by the business. In the company model, corporate social responsibility goals are an external cost, and therefore, are less likely to be prioritised by company managers if they threaten the 'bottom line'.

HOWEVER THE CURRENT REPORTING ENVIRONMENT DOES NOT ADEQUATELY MEASURE, REPORT ON OR REWARD THE VALUE CREATED BY CO-OPERATIVES AND OTHER MEMBER OWNED BUSINESS MODELS.[14]

- The CNL adopts financial auditing and reporting requirements that are largely based on the reporting requirements found in the Corporations Act.[15] It has been acknowledged that 'fair value' accounting fails to provide an accurate or holistic representation of how organisational value is created over time.[16] The Integrated Reporting Framework and Total Value Framework are alternative reporting frameworks recommended by Ernst & Young for the co-operative and mutual sectors.[17] These reporting frameworks use broader metrics to better communicate the value produced by businesses using the co-operative model including customer satisfaction and employee well-being.
- The CNL only requires (in certain circumstances) a financial audit.[18] However there is a strong case for including a regulatory requirement (in limited circumstances) for a social audit.[19] As accounting networks are increasingly engaged in measuring corporate social responsibility they are better equipped to conduct this type of audit than may have been the case a decade ago. The co-operative legal identity requires the business model not to prioritise profit, but to balance social and economic outputs to maximise member value. If

[13] *CNL* (NSW) s 192(2).
[14] Ernst&Young, 'Sticky Money -Recognising the total value created by Australian Co-operatives and Mutuals' (2014), 2.
[15] *CNL* (NSW) Part 3.3
[16] B20 Panel of six international accounting networks, 'Unlocking Investment in Infrastructure' (2014), also see Ernst&Young, above n 10.
[17] Ernst&Young, above n 10, 2.
[18] *CNL* (NSW), s 276.
[19] In Germany the societal or management audit is a feature of German co-operative law and historically it has utilised a specialised unit, the Co-operative Auditing Federation to conduct audits in a manner that is consistent with the dual social and economic role of co-operative.

the organisation is only audited for financial performance, it is understandable that co-operative managers (whose skills are often acquired in the corporate sector) may feel pressured to concentrate on financial performance at the expense of social output.

THE REGULATORY SOLUTION FOR CO-OPERATIVES IS THE INCLUSION OF INTEGRATED REPORTING AND TOTAL VALUE REPORTING FRAMEWORKS AND SOCIAL AUDIT REQUIREMENTS IN CO-OPERATIVE LEGISLATION.

ACCOUNTING STANDARDS

- Because co-operative membership is voluntary, a member who leaves the co-operative is entitled to a refund of their contribution to capital at par value. .[20] This means that members' capital contributions are treated as debt and not equity on the co-operative balance sheet.

THE APPLICATION OF INTERNATIONAL ACCOUNTING STANDARDS DESIGNED AROUND THE ACCOUNTING CONCEPTS USED FOR THE DOMINANT COMPANY MODEL DISCRIMINATES AGAINST THE CO-OPERATIVE AND CREATES A DISTORTED VIEW OF THE CO-OPERATIVE'S FINANCIAL PERFORMANCE.

- Because of the treatment of member capital as debt, the co-operative will always show unfavourable debt to equity ratios which can make it difficult for co-operatives to secure external debt finance. Arguably the conservative financial structure of the co-operative will mean that is has adequate safety nets to meet any refund to members on exit. In contrast, under the Corporations Act, companies have the benefit of being able to treat share capital as equity on the one hand but at the same time they are allowed the flexibility to buy back shares or reduce capital under Chapter 2J of *Corporations Act* 2001 (Cth). [21]
- Pressure to demutualise often occurs when the co-operative board delegates to an executive management that is familiar with company accounting and does not understand the essentially different treatment of capital in the co-operative model.

AN IDEAL REGULATORY SOLUTION IS THE DEVELOPMENT AND ADOPTION OF ACCOUNTING STANDARDS THAT ARE APPROPRIATE FOR THE CO-OPERATIVE MODEL.

- Alternative regulatory solutions involve compromising the co-operative's distinct legal identity to satisfy standards designed for the investor owned company.[22]

[20] *CNL(NSW)*, s.163.
[21] *Corporations Act* 2001 (Cth), s 254K and ss 256B, 257B
[22] The interim solution to the problem posed by IAS 32 adopted in most EU countries was to introduce into their respective co-operative laws an unconditional right to refuse the withdrawal of capital by members, the insertion of this provision was sufficient to enable co-operative capital to be treated as equity, see Gemma Garcia Fajardo, 'Co-operative Finance and Co-operative Identity' (2012) (45) *Euricse Working Paper* , 10. An overview of the problem faced by the EU co-operative and their unified response is well described in Jean-Claude Detilleux and Caroline Naett, 'Cooperatives and International Accounting Standards: the case of IAS 32' (2005) (295) *RECMA - Revue Internationale de l'Economie Sociale* 1.

CO-OPERATIVE FEDERALISM AND THE QUEST FOR UNIFORM CO-OPERATIVE LAWS

IN AUSTRALIA, CO-OPERATIVE GROWTH AND PROMOTION IS HINDERED BY THE CONSTITUTIONAL RESTRICTION ON THE COMMONWEALTH'S LAW MAKING POWERS IN RELATION TO THE 'FORMATION' OF CORPORATIONS (INCLUDING BOTH COMPANIES AND CO-OPERATIVES).

- While the states have referred their powers to the Commonwealth in relation to companies, law making powers in relation to the formation and regulation of co-operatives has remained with the states.
- One the one hand, there is an argument that state-based regulation is appropriate for co-operatives due to the predominantly localised nature of the types of businesses that tend to use the co-operative model (e.g. producer co-operatives).
- On the other hand, state based regulation of business models has tended to produce duplication of administrative and regulatory regimes that may significantly increase transaction costs for co-operative businesses who wish to transact across state borders.
- Although traditional co-operative businesses are 'local', the dual social and economic outputs of the co-operative model are attracting new types of business. These businesses are looking for a suitable model for collaborative ventures e.g. co-working spaces. The company model is less likely to be suitable because it is hierarchical and deters democratic participation. While the co-operative is a suitable model for collaborative start-ups, these new types of businesses are likely to be deterred by the 'state' focussed regulatory model which tends to be interventionist and overly prescriptive in its requirements for registration.[23]

STATE BASED LEGISLATION HAS ALSO SERIOUSLY HINDERED THE DEVELOPMENT AND GROWTH OF CROSS BORDER CO-OPERATIVE NETWORKS AND FEDERATIONS.

- These networks and federations are essential to the viability of co-operative businesses in the hyper competitive market. This is particularly the case in the agricultural sector, where networks of producer co-operatives allow small family owned businesses to survive.
- Experiments with co-operative federalism (the quest for uniform legislation in each Australian state) have generally failed to achieve the desired result for companies and co-operatives (and hence the referral of state powers for companies to the Commonwealth).
- The Co-operative National Law is an example of co-operative federalism. All Australian states and territories agreed to adopt uniform or *consistent* legislation under the Australian Uniform Co-operative Legislation Agreement (AUCLA) in 2012. To date the CNL has commenced in NSW, Vic and SA. Tasmania and Northern Territory have recently passed the

[23] An example of this prescriptive approach is in the requirements for disclosure statements in the CNL. These documents require start-ups to provide detailed information including estimates, forecasts and projections. These requirements are likely to operate as a barrier to formation for potential users of the co-operative model.

enabling legislation and Queensland and WA have agreed to adopt consistent legislation (*but not the CNL*). Even if a degree of uniformity is eventually achieved, it has proven to be almost impossible to maintain under this sort of regulatory regime.

A REGULATORY SOLUTION TO THIS OBSTACLE IS THE REFERRAL OF STATE CO-OPERATIVE LAW MAKING POWERS TO THE COMMONWEALTH FOR CO-OPERATIVES.

- The states have traditionally been reluctant to entertain this option for a range of reasons that are complex and deeply embedded in the co-operative movement's historical roots.[24] This Senate enquiry provides an opportunity for the Commonwealth to consider if it wishes to play a part in changing the course of history for co-operative businesses in Australia. Co-operatives have great potential in the modern economy to promote sustainable and inclusive growth particularly in regional Australia.
- The legal recognition of the co-operative company hybrid is an alternative solution allowing co-operatives access to the federal jurisdiction and some of the efficiencies of the company model but at the same time providing legislative protection of member control rights.

THERE IS A STRONG CASE FOR THE COMMONWEALTH TAKING AN ACTIVE ROLE IN LEGSLATION TO PROMOTE AND PROTECT THE CO-OPERATIVE BUSINESS MODEL IN AUSTRALIA. IT OFFERS A VEHICLE FOR POOLING LOCALLY OWNED RESOURCES TO SOLVE SOCIAL AND ECONOMIC PROBLEMS, PARTICULARLY IN REGIONAL AUSTRALIA WHERE LOCAL ECONOMIES ARE STRUGGLING TO SURVIVE. CO-OPERATIVES ALSO ALLOW SMALL AGRICULTURAL PRODUCERS TO CONTINUE TO MAKE AN IMPORTANT CONTRIBUTION TO FOOD SECURITY IN AUSTRALIA AND TO PRESERVE LOCAL OWNERSHIP OF LAND AND AGRICULTURAL RESOURCES. THESE ARE NATIONAL ISSUES AND REQUIRE THE ATTENTION OF NATIONAL POLICY AND LAW MAKERS.

[24] Gary Lewis, *The Democracy Principle* (Co-operative Federation of NSW Ltd, 2006), also see Lewis, above n .