NSW OFFICE OF Fair Trading DEPARTMENT OF COMMERCE for consumers & traders

CO-OPERATIVE CAPITAL UNITS AND CO-OPERATIVE PRINCIPLES

SUMMARY

Unique to the co-operatives legislation of NSW is a financial instrument named a Co-operative Capital Unit (CCU). The device was introduced as part of a major overhaul of the State's co-operatives legislation in the early 1990's that culminated in the passage of the Co-operatives Act 1992.

Although co-operatives have always been able to raise additional capital needs from non-members through the issue of debentures or subordinated debt instruments, it was seen that there was a need to provide for a more flexible fundraising instrument. One of the major recommendations of the review was the introduction of CCUs as a means of capital raising for co-operatives so as to allow for the injection of funds from external sources.

The Act allows for flexibility in designing CCUs and it is possible for a CCU to have some of the elements of an equity instrument and some of the elements of a debt instrument. In practice, and in accordance with the Act, a CCU may be structured through its terms of issue anywhere along a continuum from a redeemable preference share to an ordinary debenture.

The legislative scheme introducing CCUs hence incorporated a number of checks and balances designed to provide co-operatives with this new and flexible fund raising instrument without jeopardising co-operative principles.

The co-operative principles seen to be at risk through the inclusion in the legislation of CCUs are those relating to autonomy and independence, democratic member control and member economic participation.

The legislative checks and balances are sufficient to protect the integrity of co-operative principles and this has been borne out in practice with the small number of co-operatives that have availed themselves of this financial instrument having experienced no loss of member control.

For co-operatives to be competitive in today's markets, they need to have a means of matching increasingly powerful and resource rich organisations. If co-operatives are limited to traditional means of capital raising which do not always meet their needs then it is possible that many such organisations will be forced to adopt a different corporate structure. The availability of a flexible fund raising instrument like a CCU, does not encroach in any significant way on co-operative principles, provides a means of survival and expansion for co-peratives that require additional capital their members are unable to provide.

CO-OPERATIVE CAPITAL UNITS AND CO-OPERATIVE PRINCIPLES

Introduction

Unique to the co-operatives legislation of NSW is a financial instrument named a Co-operative Capital Unit (CCU). The device was introduced as part of a major overhaul of the State's co-operatives legislation in the early 1990's which culminated in the passage of the Co-operatives Act 1992 and consequent repeal of the Co-operation Act 1923.

The Co-operatives Act 1992 (the Act) was passed following a review of the 1923 Co-operation Act by Solicitors, Blake Dawson Waldron and Merchant Bankers, Dominguez Barry Samuel Montague Ltd. The review identified fund raising by co-operatives as one area in need of modernisation. Australian co-operatives legislation then in force was seen by some co-operatives as placing significant limitations on their ability to obtain financial accommodation from sources outside their active members.

Although co-operatives were able to raise additional capital needs from non-members through the issue of debentures or subordinated debt instruments, the authors of the review argued that there was a need to provide a more flexible fundraising instrument. One of the major recommendations of the review was therefore the introduction of CCUs as a means of capital raising for co-operatives so as to allow for the injection of funds from external sources.

While arguing that a creative mechanism for fund raising was important for both the retention of existing co-operatives as well as further growth in the co-operative sector, the authors of the review recognised that there were risks in the development of a suitable instrument. In particular, the authors were concerned to ensure that members' rights were not merged with those of external investors with a consequent dilution of member control.

The legislative scheme introducing CCUs hence incorporated a number of checks and balances designed to provide co-operatives with a new and flexible fund raising instrument which would not undermine co-operative principles.

The Legislative Scheme

The provisions governing CCUs are contained in Part 10, Division 2 of the Act titled *Funds, Property etc.*

The Act provides that a CCU is personal property and is an interest in the capital but not the share capital of a co-operative (section 269). That is, the instrument cannot be construed as being a member share conferring the rights of membership.

Before a co-operative can issue CCUs it must have rules which authorise the issue of such an instrument, and the rules must contain the minimum requirements concerning

CCUs specified in section 272. This section provides that CCU holders have the same rights as debenture holders regarding the receipt of notices of meetings of the co-operative and other documents and that each holder is entitled to one vote only at a meeting of CCU holders. Rights may only be varied according to their terms of issue if 75% of the holders approve and a CCU holder has none of the rights or entitlements of a member.

CCUs may be issued to both members and non-members (section 271). A co-operative cannot issue CCUs unless the terms of issue are first approved by members by way of special resolution and by the Registrar. The Registrar may only approve the terms of issue if satisfied that it will not result in a failure to comply with co-operative principles (section 273). By implication, the members must also approve any variation of the terms of issue by way of special resolution.

The issue of CCUs must also be accompanied by a statement approved by the Registrar for the purposes of the issue (section 273). The disclosure provisions in Division 1 of Part 10 apply to any issue of CCUs and where the issue is to non-members section 266 applies the prospectus provisions of the Corporations Law with the Registrar acting in place of the Australian Securities and Investments Commission.

The Act, at section 273, provides that certain matters must be specified in the terms of issue of CCUs. The section is not exhaustive of content but requires that the terms must contain details of entitlement to repayment of capital, entitlement to participate in surplus assets and profits, entitlement to interest on capital (whether cumulative or non-cumulative) and details of how entitlement to interest and capital are to rank for priority of payment on winding up.

In discharging their duties it is proper for directors of the co-operative to take into account that CCU holders do not have the rights of members and are not to be regarded as members (section 274).

To ensure that member capital is not eroded the Act provides that CCUs may only be redeemed out of profits that would otherwise be available for dividends or out of the proceeds of a fresh issue of shares or an approved issue of CCUs (section 275). Redemption of a CCU, other than by way of a fresh issue of shares, requires the co-operative to transfer to a capital redemption reserve, profits equal to the nominal amount of CCUs redeemed (section 276). Because CCUs are not part of the share capital of a co-operative, their redemption does not constitute a reduction in share capital (section 275(1)).

So what exactly is a CCU?

The answer to this question lies in the terms of issue of any particular CCU. The Act allows for flexibility in designing CCUs and it is possible for a CCU to have some of the elements of an equity instrument and some of the elements of a debt instrument. The hybrid nature of CCUs has led to the instrument being described by Mr Slater of counsel as "a class of property *sui generis* which (is) neither share, debenture, nor

debt". In practice, and in accordance with the Act, a CCU may be structured through its terms of issue anywhere along a continuum from a redeemable preference share to an ordinary debenture.

Co-operative Capital Units in practice

To date seven NSW co-operatives have issued CCUs. Two issues were available to public investors, four were confined to active members of the co-operative and one issue was to persons, who, while not members of the co-operative, were treated in most respects as if they had membership status. Relevant parts of the terms of issue are summarised below in relation to the three co-operatives which still have CCUs on issue at 30 June 2006.

Norco Co-operative Limited

In 1993 and again in 1994, Norco, a co-operative with 700 members, made an issue of CCUs (here named NCUs) with the offer being open to public investors within NSW. The co-operative hoped to raise $10 million in order to reduce its bank debt and replace this with borrowings at lower rates of interest.

The NCUs were of two types – short or medium term - having different rates of interest calculated at 1-2% above current bank deposit rates, with interest capped at 10%. Short term NCUs were redeemable on six months notice and medium term at 12 months notice, with either being redeemable sooner with board consent. Redemption could not occur if the co-operative was experiencing losses. The instruments were capable of transfer with board consent.

NCU holders had no right to attend meetings of the co-operative.

On wind up NCU holders ranked behind ordinary creditors but ahead of members for repayment of capital. Interest due ranked equally with unsecured creditors. There was no right to participate in surplus assets on wind up.

The capital raised by the NCU issue fell well short of the desired $10 million with only $2 million being raised. At 30 June 2006 there was $198,000 of NCUs outstanding.

The balance sheet listed these instruments as debt which accords with their terms of issue.

Namoi Cotton Co-operative Limited

In March 1998 Namoi Cotton made a public issue of $44 million in CCUs entitled Namoi Capital Stock raising $35million. The issue followed a court approved Scheme of Arrangement voted upon by members, which involved the issue of 56 million CCUs to existing grower members. The driving force for these issues was a need to raise additional capital to meet the operational needs of the co-operative, which could not be provided through its membership.

Namoi capital stock is non-redeemable and permanent capital. The fortunes of stockholders are linked to the success of the enterprise with dividend distributions being determined by the board. The stock is freely tradeable on the Australian Stock Exchange and for listing purposes the ASX has indicated that the stock will be treated as ordinary shares.

Stock holders are entitled to share with members equally in the distribution of surplus assets on wind up, in proportion to their holding, but after the capital of member shareholders has been repaid.

Holders of Namoi Capital Stock are entitled to nominate up to three independent directors and attend meetings of grower members but may not vote. The co-operative has a total of seven directors.

Capital raising through the stock issue reached the anticipated $35 million which is significant by comparison with member share capital (known as "grower member shares") which, at 30 June 2006 had a fixed capital entitlement of $907,000. Although the Registry does not have access to data on stock holding, it is believed that a large number of stockholders are also active members of the co-operative.

Namoi Capital Stock has more of the characteristics of equity than debt as indicated by the terms of issue, its classification on the balance sheet, and the fact that it is listed on the Australian Stock Exchange.

Walgett Special 1 Co-operative Limited

Walgett Special 1 Co-operative has the objects of purchasing grain from its members and supplying members with agricultural inputs.

Over the period 2000 to 2003, with the aim of improving its capital base, the Co-operative issued CCUs, known as Co-operative Patronage Units (CPUs) to its members. The conditions of issue also provide that CPUs may be issued to small superannuation funds with a member connection. A member must not apply during in any year for more than a maximum number of CPUs as determined by a formula based on tonnes of grain supplied.

CPUs are entitled to an interest rate of between 4% and 20% as set by the board of directors each year. In addition bonus interest may be declared by the board at an annual general meeting and is based on the previous year's patronage.

Each holder of CPUs has one vote only on matters relating to the CPUs, irrespective of the number of CPUs held. A relevant interest in CPUs by any member is limited to 20% without a special resolution of members.

Redemption of CPUs is at the option of the board or by a former member on the giving of 21 days notice after cessation of membership.

On winding up, claims for interest on CPUs rank equally with claims by members for dividends and rebates and repayment of principal ranks equally with repayment of share capital.

The Co-operative shall not issue more than $5million in CPUs without member approval. At 30 June 2006 the Co-operative had approximately $677,000 on issue.

The CPUs have the same characteristics as shares and are classified in the balance sheet as a liability, together with shares, in accordance with current accounting standards.

Co-operative principles and CCUs

The Co-operative principles are incorporated in the Act at section 6. These are as follows:

1. Voluntary and open membership
2. Democratic member control
3. Member economic participation
4. Autonomy and independence
5. Education, training and information
6. Co-operation among co-operatives
7. Concern for the community

The co-operative principles seen to be at risk through the inclusion in the legislation of CCUs are those relating to autonomy and independence, democratic member control and member economic participation. The issue of CCUs to members is unlikely to be of concern except to the extent that any entitlement to surpluses may erode the capacity of the co-operative to pursue its primary activity or develop the co-operative. However, given the limitations of raising capital from members this is not regarded as a significant threat to co-operative principles. The following discussion therefore deals primarily with the issue of CCUs to non-members.

There is a fear that the issue of CCUs could dilute member control where the capital provided by CCU holders is such that its withdrawal would threaten the viability of the co-operative. Further, there is concern that external pressure could influence the operation of the co-operative so eroding its autonomy.

The thread running through the principle of member economic control is that a co-operative is established for the benefit of its members and as such surplus or profits should be distributed equitably amongst members according to their patronage. There is a perceived possibility that a co-operative that engages in raising capital from non-members may become capital driven rather than member driven.

The response to the above concerns relies upon two arguments. First, that the checks and balances provided in the Act are sufficient to secure co-operative principles against any erosion. Second, that the implementation of the legislation governing CCUs in NSW has protected the integrity of these principles.

1. Checks and balances in the Act

The legislative framework as detailed above goes to some lengths to ensure that there is full member participation in any issue of CCUs. A co-operative may only issue

CCUs where members have first approved of rules to permit this. Where a co-operative's rules authorise the issue of CCUs the terms attaching to any issue require member approval by way of special resolution as well as the approval of the Registrar. By implication, approval of the members and the Registrar is also required for any variation of the terms. In giving approval the Registrar has a statutory obligation be satisfied that the terms of issue are compatible with co-operative principles. Further, the issue must be accompanied by a statement, approved by the Registrar, which outlines the details and effect of the terms of issue.

Chapter 6D of the Corporations Law applies to CCU issues made to persons outside the membership of a co-operative (sections 266 and 270). Consequently, a co-operative intending to issue CCUs to non-members within New South Wales must produce a prospectus approved by the Registrar. The prospectus must contain information that is reasonable for investors and their professional advisers to expect to be included in a prospectus for a CCU issue. Issues outside of New South Wales are governed by the Corporations Law applied by the Australian Securities and Investments Commission.

Where a CCU issue is made solely to the members of a co-operative, or to the members and employees of a co-operative, the co-operative must issue to prospective CCU holders, a disclosure statement approved by the Registrar and complying with the Act. The statement must contain such information as is reasonably necessary to enable a person to make an informed assessment of the financial prospects of the co-operative (section 266A). This information includes the purpose of the issue, the rights and liabilities attaching to the CCUs, the financial position of the co-operative, the interests of the directors and such other matters as the Registrar directs. Although the Act's provisions appear less detailed those under the Corporations Law, the Registrar's discretion, if necessary, is exercised to require a level of disclosure suitable to the circumstances so that members are appropriately informed.

The Act specifically provides that CCU holders do not have the rights and entitlements of a member and the legislation provides that it is proper for the board to take note of this in discharging its duties.

While the terms of issue of CCUs may give the holders a right to nominate directors, as occurred in the Namoi issue, they have no entitlement to vote for board members or to remove any director. Hence CCU holders can never be in any direct position to influence management.

2. Practical consequences of the issue of CCUs

Of the five NSW co-operatives that have issued CCUs three have issued outside their membership. In the case of Norco and Namoi the purpose of the issue was to gain an injection of capital into the organisation. In the case of ABC Taxis, the co-operative identified a group of people who contributed to its operation and wished to provide them with an opportunity to invest and gain some benefits in a similar manner to members.

Undoubtedly it is the Namoi issue which has excited the most concern amongst the purist supporters of co-operative principles. Stock holders have the right to nominate

(but not vote for) two independent directors to the board and there is no arguing that the extent of the non-member capital could influence management.

A related question is what remedies the Stock holders would have if the affairs of Namoi were to be conducted in an oppressive manner to them. One of the terms of issue is that the directors must ensure that the affairs of the co-operative are not conducted in a manner that is "oppressive, or unfairly prejudicial to, or unfairly discriminating against a holder of NCS, or in a manner that is contrary to the interests of NCS holders as a whole". This is reflective of the language of section 96 of the Co-operatives Act and section 232 of the Corporations Law with respect to the rights of members of co-operatives and companies.

As a Stock holder, a person can have none of the rights and entitlements of a member. Accordingly, it would seem that, as non-members, the Stock holders would not be able to bring actions for oppressive conduct, either under the Act or the decided cases in respect of companies. So far, the courts have found that a board only owes a fiduciary duty to consider the interests of creditors when the company is approaching insolvency (*Kinsela v Kinsela Pty Ltd (in liq) 1986 4 NSWLR 722)*. However it is clear that this duty is one that the company, and not the creditors, may enforce (*Spies v The Queen 74 ALJR 1263*). On the other hand, the contractual rights Stock holders have under the terms of issue would seem to give them a right to enforcement action concerning oppression. There is, however, a complicating factor, in that the Act provides that it is proper for the directors to have regard to the fact that CCU holders have none of the rights and entitlements of members.

Whatever the result, it is important to recognise that the Namoi arrangement occurred with the full knowledge and consent of active members who wished to retain the co-operative structure but, in the absence of fresh funds, would not have been able to do so. In this regard, in his decision on Namoi's Scheme of Arrangement, Santow J. commented that the Co-operatives Act, by introducing CCUs as a capital raising technique for co-operatives, reflected the evolving nature of a modern large scale co-operative – a body run for the benefit of its members, but impelled by expansion to introduce outside investors (*Re Namoi Cotton Co-operative Ltd (1997) ACLC 4*98).

Of particular significance is the fact that the Registry has received no complaints from members of any of the co-operatives that have issued CCUs, about any perceived loss of member control or, in relation to ABC Taxis, Norco or Namoi, about the distribution of profits outside membership.

In summary, it is hard to avoid the conclusion that the existence of CCUs in NSW co-operatives legislation has been something of a non-event. The five co-operatives that have trialed the financial instrument have done so for reasons peculiar to their own particular undertaking. They have experienced varying degrees of success in achieving the desired outcome by use of CCUs but in no case have members considered that co-operative principles were under any real threat.

Conclusion

It has been fifteen years since CCUs were introduced into NSW co-operatives legislation. Co-operatives have been cautious about adopting the instrument, with only 7 out of total 750 co-operatives making a CCU issue. Four issues were limited to active members, two were available to public investors and one was made to persons outside membership who had been treated by the co-operative as if they were active members and two were made to the public.

The terms of issue of each of the CCUs has determined their status as either debt or equity.

In practice the existence of CCUs as a financial instrument has given co-operatives an alternative way of raising funds, either from within or outside of membership, thus providing monies for short term or urgent requirements, or as a means of restructuring the capital of the co-operative.

This paper has argued that the legislative checks and balances are sufficient to protect the integrity of co-operative principles and that this has been borne out in practice with the small number of co-operatives that have availed themselves of this financial instrument having experienced no loss of member control.

It is important to recognise that for co-operatives to be competitive in today's markets they need to have a means of matching increasingly powerful and resource rich organisations. If co-operatives are limited to traditional means of capital raising which do not always meet their needs then it is possible that many such organisations will be forced to adopt a different corporate structure. Some may argue that this is inevitable. However, co-operatives are distinctly different from companies under Corporations Law, particularly with respect to member democratic control and member economic participation. Why should co-operatives be forced to abandon their member based legal structure? The availability of a flexible fund raising instrument like a CCU, which, it is argued, does not encroach in any significant way on co-operative principles, provides a means of survival and expansion for co-operatives that require additional capital their members are unable to provide.