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The *Co-operatives and Community Benefit Societies Bill*

Bill 15 of 2002-03

Mark Todd (South Derbyshire) came first in the 2002 ballot for Private Members' Bills. The *Co-operatives and Community Benefit Societies Bill* is to have its Second Reading on 31 January 2003.

The Bill would allow members of community benefit societies to 'lock-in' the society's assets as a protection against demutualisation. It also reforms aspects of the law which applies to community benefit societies and co-operatives to bring it into line with modern company law.

Supporters of mutual organisations argue that community benefit societies could play an important role in delivering public services while allowing for community ownership and participation. The Bill builds on Gareth Thomas' successful Private Members' Bill, the *Industrial and Provident Societies Act 2002*, and the subsequent recommendations of the government's Strategy Unit report, *Private Action, Public Benefit*.

Christopher Blair

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Summary of main points

- An Industrial and Provident Society ('I & P society') is a corporate form which is used by co-operatives and certain organisations which provide a benefit to the community ('community benefit societies'), including many housing associations and clubs.

- Registration under the *Industrial and Provident Societies Act 1965* gives such organisations legal status, continuing existence and limited liability while allowing their governance structure to reflect a mutual ethos distinct from conventional corporate principles.

- The form is increasingly suggested as a model for securing community assets while delivering public services based on them.

- The governing legislation is now outdated in comparison to company law and it is argued that this acts as a disincentive to wider use of the I & P form.

- Initial reforms were made in the *Industrial and Provident Societies Act 2002*, a Private Members' Bill promoted by Gareth Thomas (Harrow West).

- The present Bill would allow members of community benefit societies to alter their rules so as to prevent their assets being distributed except to other bodies with equivalent purposes (clause 1).

- Provisions for such an 'asset lock' had been withdrawn from Gareth Thomas' Bill in the face of government concerns about the wider effects of such a lock.

- However, in September 2002, the government's Strategy Unit (in *Private Action, Public Benefit*) recommended that community benefit societies should be permitted to protect their assets in perpetuity for a public purpose.

- The Bill would also bring I & P law into line with modern company law on the effect on third parties of actions taken by the company which are beyond its capacity (the *ultra vires* rule: clause 2), and the role of the corporate seal (clause 3).

- This paper updates Research Paper 02/08, The *Industrial and Provident Societies Bill* (Bill 14 of 2001-02).

- The Bill applies to England, Wales and Scotland.

CONTENTS

I Industrial and Provident Societies

A. Historical background

An industrial and provident society, from a legal perspective, is a society which is registered under the *Industrial and Provident Societies Act 1965* (IPSA 1965). The Act allows two broad types of organisation to be registered: co-operatives and community benefit societies.[1] More will be said about how these categories are interpreted later, but at the moment it is enough to observe that the activities which are carried on by societies registered under the 1965 Act are very varied. In particular, registration is not restricted to organisations which have industrial or providential purposes.[2] A recent government study has suggested that the form's name should be changed to 'Co-operatives and Community Benefit Societies' so as to boost its recognition and popularity.[3]

Industrial and provident societies are part of the mutual sector and trace their origins back to another mutual form, the friendly society.[4] In their first state, they were trading societies 'the purposes of which were to make profits by the personal exertions of their members, and to distribute the profits by way of provident provision for their members' future'.[5] Early societies were formed as friendly societies taking advantage of legislation in 1834 which allowed friendly societies to be formed for any purpose which was not illegal.[6]

In 1852, the *Industrial and Provident Societies Partnership Act* was passed. Its promoter described its purpose as 'to enable poor people with small sums invested in partnership transactions to have recourse where necessary to a cheap tribunal, and to bring those small partnerships within the meaning of the Friendly Societies' Act'.[7] The preamble to the Bill referred to activities carried on by industrial and provident societies:

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1 IPSA 1965 s. 1(2)

2 *Provident* **'**Foreseeing; that has foresight of and makes provision for the future, or for some future event; exercising or characterized by foresight' (*Oxford English Dictionary*, sense 1)

3 Strategy Unit, *Private Action, Public Benefit: A review of charities and the wider not-for-profit sector*, September 2002, para 5.35 ('Strategy Unit')

4 *Friendly Society* 'Originally, the name of a particular fire-insurance company. In later use, one of numerous associations, the members of which pay fixed contributions to insure pecuniary help in sickness or old age, and provision for their families in the event of death.' (*Oxford English Dictionary*, sense 8) Friendly societies nowadays continue to provide insurance and savings facilities on a mutual basis under their own specific legislation.

5 See 'Industrial and Provident Societies: Nature and early legislation', *Halsbury's Laws of England*, on which this historical account draws.

6 Ibid. The *Oxford English Dictionary* regards a provident society as synonymous with a friendly society.

7 R.A. Slaney (Shrewsbury) HC (3rd series) 21 April 1852 vol 120 c967

> …whereas various Associations of Working Men have been formed for the mutual Relief, Maintenance, Education and Endowment of the Members, their Husbands, Wives, Children, or Kindred, and for procuring to them Food, Lodging, Clothing, and other Necessaries, by exercising or carrying on in common their respective Trades or Handicrafts;[8]

The Act itself put the legality of forming industrial and provident societies beyond doubt and made the newly-recognised form of society subject to the regulation then applying to friendly societies. The Act also made provision for certain features which had to be included in the rules of industrial and provident societies. Up to one third of a society's profits could be shared amongst the members, in addition to their being paid for their work. The remainder of the profits were to be applied to building up the society's capital or to any provident purpose lawful for a friendly society. These industrial and provident societies were therefore exclusively co-operative ventures: 'carrying on or exercising in common any Labour, Trade, or Handicraft'.[9]

Halsburys Laws summarises the later evolution of industrial and provident society legislation:

> An Act of 1862 conferred incorporation on societies registered under it and limited the liability of their members.
>
> In 1893 the law relating to industrial and provident societies was consolidated in the *Industrial and Provident Societies Act 1893*, which was amended by a number of Acts passed between 1894 and 1961. The law was again consolidated in the *Industrial and Provident Societies Act 1965*, which remains the principal statute governing industrial and provident societies.[10]

II Demutualisation and new mutuals

A. Demutualisation

Mutual organisations have a long history in the UK. For example, the provision of financial support to members who are unable to work was a feature of the medieval craft guilds before friendly societies developed a similar role in the early nineteenth century. The late eighteenth century and the early to mid nineteenth century saw a growth in the range of mutual organisations, from terminating and permanent building societies, to friendly societies to industrial and provident societies. The origins of the modern co-

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8 15 & 16 Vict. c 31 (*Industrial and Provident Societies Partnership Act 1852*)

9 Ibid. s.1

10 'Industrial and Provident Societies: Nature and early legislation', *Halsbury's Laws of England*

operative movement are usually traced to the establishment of the Rochdale Society of Equitable Pioneers in 1844. Many organisations founded in the nineteenth century persist today although often they have merged and changed names.

In recent years, especially in the mid 1990s, demutualisation has been more prominent than the formation of new mutuals. Many of the largest building societies - including the Halifax, the Woolwich and the Alliance & Leicester - left the mutual sector either by being acquired by existing companies or by converting into companies. In the four years from 1995 to 1999 nine former building societies headed for the corporate sector, taking with them two thirds of the total assets which the sector had had in 1994. [11]

These conversions were typically accompanied by substantial 'windfall' payments to some members of these societies. Those in favour of demutualisation spoke of the need for building societies to diversify, to access corporate capital in order to compete with the banks and of the limited value of membership rights when they were locked up in large building societies with millions of members. Those against spoke of the lower cost of capital to societies (who do not need to reward shareholders) and of the positive alignment in mutual building societies of the interests of members and customers. But for many the issues were more narrowly focused on windfall gains: on the fairness of distributing accrued surpluses only to current members; on complex rules which restricted the entitlement of some current members to a distribution; and on the desirability of dismantling organisations which had been built on a distinctive mutual basis in order to attain short term gains.

Demutualisation has also occurred at many formerly mutual insurance companies: the arguments for demutualisation in these cases have tended to focus on the need for greater capital. In both insurance companies and building societies expectations rapidly developed of further conversions and further windfalls. This led to much speculative account opening by individuals - dubbed carpetbaggers - who hoped that the acquisition of membership rights would in future entitle them to windfall distributions. While the rights and wrongs of carpetbagging are disputed, the sudden growth in new accounts (often with the minimum opening balance) caused significant disruption to the operation of many mutuals.[12]

1997 saw an audacious bid by a young financier, Andrew Regan, for the control of another long-established mutual organisation, the Co-operative Wholesale Society. Regan, who had already bought the CWS's food-manufacturing arm Hobson in an earlier deal, assembled bid finance and top advisers for his Lanica Trust which sought to acquire the Co-op for £1.2 Billion. It was understood that the various Co-op businesses would

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[11] Only eight conversions actually took place since the Leeds Permanent merged with the Halifax prior to conversion. Building Society Association in evidence to the Treasury Committee, *Demutualisation*, 9 July 1999 HC 605-I 1998-1999, para 5

[12] Compare Save Our Building Societies (SOBS) (www.sobs.org.uk) with Carpetbagger.com (www.mywebcommunities.com/carpetbagger)

then be sold off separately in an asset-stripping exercise. The bid collapsed amidst revelations that confidential information had been leaked to the bidders. The backers withdrew and a leading merchant bank was forced to apologise for its role in the affair. The Serious Fraud Office was called in and Regan has since twice been put on trial for theft charges related to activities at Hobson before the bid. Neither trial has proceeded to a verdict in respect of Regan: in January 2003 the jury was discharged unexpectedly in the trial's second week. Although the CWS fought the bid effectively, it acted as a salutary warning to co-operatives generally.

Faced with a threat to its future existence, the mutual sector fought back. The outgoing Conservative Government passed the *Building Societies Act 1997*, which gave the sector additional freedoms. The incoming Labour Government in 1997 made one small adjustment to building society law but also made it clear the sector should not look to legislative assistance in order to survive. Helen Liddell, as Economic Secretary to the Treasury, expected the mutual sector to promote the benefits of mutuality itself:

> 'Mutuality does have a future. Millions in the country do believe in it. And it is worth fighting for. But you have to be in the front line. The more people who know and understand the benefits of mutuality, the less likely they are to be seduced by the arguments for conversion or takeover.'[13]

The largest building society, Nationwide is a case in point. Like many building societies it introduced provisions which removed the attractions of carpetbagging by allocating any future windfall on new accounts to a charitable foundation rather than the account holder. It launched a Member Benefit Initiative in February 1997 under which it chose to cut back its profits and return them to members in the form of better mortgage and savings rates. Then in mid 1998 it narrowly defeated a conversion resolution. More recently it has opted to stop competing aggressively for new mortgage accounts (through heavily discounted offers) in favour of 'fairer' prices across the mortgage book. While the move had been strongly criticised by some, others see it as a positive demonstration of the long-term perspective which mutuality allows the society.

The defeat of a conversion motion at mutual insurer Standard Life, in June 2000, has also been hailed as a significant turning point in the tide towards demutualisation.

B. New mutuals

There are signs that the mutual sector may even be entering a period of expansion. The Government has been working with the credit union sector (mutual banks registered under the 1965 Act) to promote practices associated with sustainable credit union growth as part of the social exclusion initiatives. Meanwhile theorists are arguing that the mutual

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[13] *Promote mutuality: Helen Liddell*, HM Treasury press release 139/97, 13 November 1997

form may hold the key to solving difficult issues about the respective roles of the public and private sectors in delivering public and community services. The solution is based on a form of ownership which fosters community involvement but which preserves the public assets for community use.

In a pamphlet written for the think tank Mutuo, Cliff Mills explains:

> The new mutual form of ownership is a radical new approach, but based on established principles and legislation. It is aimed at providing an alternative form of corporate model for the ownership of public services.
>
> The starting point for the model is that public services are needed for the benefit of communities, and the individuals and organisations that make up communities. I have an interest in electricity, gas, water, transport and similar services being available, not just so that I have access to them when needed for my personal and worktime use, but also so that the community in which I live can function….. Public services therefore serve communities. It would be logical for them to be held within a structure focussed on serving the community and committed to carrying on its business for the benefit of the community.
>
> This is precisely the model which is used - a mutual organisation registered under the Industrial and Provident Societies Act on the basis that it is conducting its business for the benefit of the community.[14]

Mills argues that the shareholder model (used in registered companies) has been very successful as a wealth-generating vehicle but is constrained by law to put the interests of its shareholders above other legitimate interests. He sees the industrial and provident society form as an appropriate alternative structure for those organisations which provide community services or which hold assets which could be described as community assets. Among its potential benefits are 'local community control, a constitutional role for employees, the encouragement of citizenship, and the promotion of the long-term interests of the community'.[15]

Elsewhere, Mills has observed that:

> one of the most important issues facing the Government at present concerns the appropriate mechanism for delivering public services. In the UK we have moved from transport and utility services owned by private enterprise, through nationalisation to state-owned and controlled services; and then back again in a number of areas to privately-owned services with a state-appointed regulator. The latter has not been an overwhelming success, and there are those who believe

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[14] Ian Hargreaves, Cliff Mills and Jonathan Michie, *Ownership matters: New mutual business models,* Mutuo (2001) pp15-16

[15] Ibid. p21

> that further transition is necessary. A move to a community-based form of ownership is one possibility.[16]

There are already around 8,000 industrial and provident societies in operation (and there are further organisations which are registered under the *Friendly Societies Act 1974* with similar activities). Areas in which the new model is being considered include housing, where a new form of society seeks to provide greater openness and democracy than traditional housing associations by providing greater tenant involvement.[17] The mutual think-tank Mutuo is developing a model which it hopes will soon be used as the basis for some local authority housing stock transfers. In the utility sector there has been considerable interest (albeit with concerns from the regulator) about community-owned water companies and Plas Cymru is already operating in Wales. There are further examples of community mutuals in the administration of local authority leisure services in Greenwich and in the successful establishment of football supporters' trusts at many league clubs. These supporters' trusts (registered as industrial and provident societies) are backed by the Department for Culture, Media and Sport in an initiative to encourage fans to become involved in the running of their clubs under a model which is linked to ownership.[18] Trusts have been established at most major clubs and in some cases have played a decisive role in determining the future of the club.

Other areas where the industrial and provident model has been suggested as a suitable structure for owning public or community assets and the delivery of services include in the provision of care for the elderly, pre-school childcare and the services of cemeteries and crematoria.[19] The government has recently adopted similar mutual principles as the model for the governance arrangements for its controversial foundation hospitals.[20]

On the co-operative side, in February 2000 the Co-operative Commission was set up with the backing of the Prime Minister to look at the co-operative sector and propose ways to modernise and invigorate the movement. John Monks of the TUC was asked to chair the Commission whose members included Hazel Blears MP and Lord Simon of Highbury. It Commission reported in January 2001, and the Prime Minister contributed a foreword to the report in which he wrote: 'I believe, too, that it is important that the Co-operative Movement does continue to prosper in the new century'.[21] The report made many detailed recommendations which are designed to transform the movement into a more efficient business, which continues to reflect its distinctive principles in a society which is

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16 Cliff Mills, 'Protecting public and community assets' in *Journal of Co-operative Studies*, December 2002

17 Nic Bliss et al., *Transferring ownership: Community empowerment in social housing*, Mutuo (2001)

18 Supporters Direct (www.supporters-direct.org)

19 See for example Stephen Burke and others, *Child's play: New mutual models for childcare*, Mutuo, June 2002 and Hazel Blears, Cliff Mills and Peter Hunt, *Making healthcare mutual: a publicly funded, locally accountable NHS*, Mutuo, December 2002

20 Department of Health, *A guide to NHS foundation trusts*, December 2002

21 *The Co-operative advantage: Creating a successful family of co-operative businesses*, Report of the Co-operative Commission, January 2001

more aware of the value of co-operation. A number of its recommendations are pertinent to this Bill, including providing greater protection for mutuals and the reform of the industrial and provident societies legislation.[22]

Writing for *Public Finance* magazine in 2002, Gareth Thomas has said:

> The pressing need to restore public faith in institutions, and to foster a more active and engaged form of citizenship, must lead us to increase the opportunities for community-based organisations that not only produce efficient and cost-effective services, but also engage people directly in decision-making processes.[23]

Making the case for further reforms, Mark Todd argues that his Bill:

> will offer new ways of organising public services based on stronger community ownership and participation. Many of our public services are bureaucratically distant from the citizens they serve, with local people having no stake in those services. I seek to provide a means to close that gap.[24]

C. Industrial and Provident Societies today

1. Registration criteria

In order to be registered under the 1965 Act, a prospective industrial and provident society must meet the criteria which are set out in section 1 of that Act.[25] In terms of activities, there are few restrictions: a society 'for carrying on any industry, business or trade …. whether wholesale or retail' can be registered.[26] The society must also have a registered office in Great Britain or the Channel Islands and its rules must make provision for the matters which are set out in Schedule 1 of the Act (which concern the internal organisation of the society). What makes industrial and provident societies distinct is the additional requirement that to be registered a society must fall within one of two classes. It must either be:

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22 See recommendation 29 on the security of co-operative assets and recommendations 50 and 51 on modernising legislation.

23 Gareth Thomas 'Curbing the carpetbagger', *Public Finance*, 18 January 2002

24 Mark Todd, press release, *Mark reveals subject of his Private Members' Bill*, 2 December 2002

25 By virtue of s.1 of the *Credit Unions Act 1979* credit unions are also registered under the IPSA 1965. Their legislation is primarily set out in the 1979 Act and they are not considered in detail in the rest of this Research Paper. Some societies which would now be registered under the 1965 Act are still registered under the *Friendly Societies Act 1974*.

26 IPSA 1965, s.1(1). Banking business is not permitted, however, if the society has withdrawable share capital.

- a bona fide co-operative society[27] or

- its business must be conducted for the benefit of the community *and* there must be special reasons why the society should be registered as an industrial and provident society rather than as a company.[28]

The two grounds for qualification are different in kind, since a co-operative venture is made up of individuals who pool their resources to work for the collective interests of the co-operative's own members, whereas members of societies which are established for the community benefit participate in an organisation where the benefits are provided to a wider class of beneficiaries than the members alone. The next paragraphs elaborate further on how these criteria are interpreted but in practice the distinction in the breadth of the aims of co-operatives and community benefit societies is less stark since there is a long tradition of community involvement by co-operatives.

The 1965 Act does not provide an interpretation of the registration criteria but guidance has been developed by the bodies which have responsibility for registering industrial and provident societies under the Act. The current registrar is the Mutual Societies Registration unit of the Financial Services Authority (FSA), which acquired statutory responsibility on 1 December 2001 under the *Financial Services and Markets Act 2000*. Before, responsibility lay with the Chief Registrar at the Registry of Friendly Societies.

Guidance from the FSA as to what is a bona fide co-operative refers to six conditions which an applicant for registration will normally have satisfy:

- **community of interest** There should be a common economic, social or cultural need and/ or interest amongst all members of the co-operative.

- **conduct of business** The business will be run for the mutual benefit of the members, so that the benefit members obtain will stem principally from their participation in the business.

- **control** Control of the society lies with all of the members …. In general, the principle of "one member, one vote" should apply.

- **interest on share and loan capital** Where part of the business capital is the common property of the co-operative, members should receive only limited compensation (if any) on any share or loan capital which they subscribe.

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[27] IPSA 1965 s.1(2)(a). This type of society will be referred to as a 'co-operative'

[28] IPSA 1965 s.1(2)(b). This type of industrial and provident society is referred to in this paper as a 'community benefit society'. The abbreviation 'bencom' is sometimes also used (for example in the consultation paper issued by the Treasury in 1998).

- **profits** If the rules of the society allow profits to be distributed, they must be distributed amongst the members in accordance with those rules. Each member should receive an amount that reflects the extent to which they have traded with the society or taken part in its business.

- **restriction on membership** There should normally be open membership. This should not be artificially restricted to increase the value of the rights and interests of current members…[29]

As the guidance notes, the first four of these conditions - community of interest, conduct of business, control, and interest on share and loan capital - are based on a set of seven principles of 'co-operative identity' drawn up by the International Co-operative Alliance in 1995. Those principles are set out in full at the end of this paper.

Community benefit societies are primarily characterised by the registration authority as societies which are intended through their activities to benefit the community at large rather than just their members. There are two elements to the statutory test: the society's business must be conducted for the benefit of the community and there must be special reasons why the society should be registered under the 1965 Act and not under company legislation. In other words, the fact that a society's business is conducted for the benefit of the community is not in itself a special reason for registration. The legislation does not define special reasons, but the guidance suggests that what is required is a concrete advantage or benefit that would be gained by registration under the 1965 Act or would be lost or unobtainable if the entity were to register or re-register as a company. Among the examples of special reasons cited by the guidance is a desire to operate on the basis of 'one member, one vote' (as opposed to registered companies where each share has a vote) or practical business reasons.

Societies need to meet the registration requirements on an ongoing basis, so for many societies which are already registered, a special reason might be the prohibitive cost of converting to a registered company. In all cases, the special reason needs to be demonstrated to the registration authority.

2. Governance and regulation

Registration under the 1965 Act makes a society a body corporate with limited liability, perpetual succession and the power to sue and be sued in its own name.[30] While these features help distinguish societies from unincorporated associations, a comparison with

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[29] Source: *Information on the registration of Bona Fide Co-operative Societies under the Industrial and Provident Societies Act 1965*, FSA Mutual Societies Registration guidance note. The guidance has been shortened for the purpose of this Research Paper.

[30] IPSA 1965 s.3

companies which are incorporated under the *Companies Act 1985* shows that the governance requirements and regulatory structure for societies is prescribed in much less detail. There are broad similarities, though. Just as the internal organisation of companies is set out in their Articles of Association so for societies their rules prescribe the terms on which the members associate. The 1965 Act makes provision for some matters which have to be dealt with in the rules but it does not in every case prescribe how those matters must be dealt with.

Schedule 1 to the 1965 Act requires that the rules deal with such matters as:

- the society's name
- its objects
- its place of registration
- the terms on which members join the society
- the rules for holding meetings and voting at meetings
- how rules are to be made and altered
- the appointment and powers of a committee, officers and managers
- whether shares in the society will be transferable or withdrawable, and if so, how
- the mode of application of profits
- the custody and use of the society's seal
- investment powers

The Act constrains the scope of these rules in many cases. While a prospective society is able to draw up its own rules from scratch, many adopt model rules (tailored as appropriate) which are promulgated by a number of sponsoring bodies. Current sponsors provide, for example, a wide range of model rules designed for use in sheltered housing developments, worker co-operatives, allotment societies, working men's and political clubs, and retail societies.[31] Societies which use model rules pay a lower registration fee (since the validity of the model rules has already been examined) and receive support from the sponsor in applying the rules to their circumstances.

The registration authority for societies is now the Financial Services Authority, but its regulatory role and in particular its powers of intervention over societies are much more restricted than those who are familiar with the FSA's powers over investment businesses might expect. The key function is the registration of societies whose rules are in conformity with the Industrial and Provident Societies Acts. Each society also makes an annual return to the FSA which includes a copy of the accounts. Significant changes to the society must be notified to the FSA including rule changes, changes in name and changes in the registered office. The FSA also has duties in relation to the deregistration of societies.

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[31] *Sponsoring bodies*, a guidance leaflet which gives contact details, is available from Mutual Societies Registration at the Financial Services Authority

The documents which are deposited with the FSA form a public register which may be inspected by members of the public and copied (for a fee). The FSA can in very limited circumstances initiate action to cancel the registration of a society (including for certain wilful breaches of the 1965 Act) and has limited powers to require the production of information.[32] The FSA can also, at the request of a specified proportion of members of a society, appoint an expert to examine a society's books or an inspector to report on a society's affairs.[33] In general, though, in its own words, 'the FSA does not have wide-ranging regulatory or prudential supervisory powers in relation to industrial and provident societies'.[34]

Some industrial and provident societies are subject to additional regulation from other sectoral bodies which oversee their specific activities, for example the Housing Corporation in the housing sector.

3. The sector

At the end of 2000, the 8,382 industrial and provident societies on the register held assets of £61 Billion.[35] For the purposes of analysis, the Registry divided industrial and provident societies into seven broad categories:

- **retail societies** including small one-store co-operatives, supermarkets and department stores

- **wholesale and productive societies** with members from a wide range of sectors. They include worker co-operatives, societies which buy in bulk for their retail trade members and societies which make and sell footwear

- **agricultural societies** include those which supply their members with key commodities such as seeds, fertiliser and animal feed. Also included are societies which market their members' produce; Women's Institute market societies; and allotment societies

- **fishing societies** perform a similar role to agricultural societies, supplying fishing equipment to members and marketing facilities for the catch

- **clubs** provide social and recreational facilities. This numerous category includes clubs affiliated to two very large bodies, the Royal British Legion and the Working Men's Club and Institute Union (CIU)

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32 IPSA 1965 ss16, 48

33 IPSA 1965 ss47, 49

34 *Industrial and Provident Societies: Some of your questions answered*, FSA Mutual Societies Registration guidance note

35 Source: *Annual report of the Registry of Friendly Societies 2000-2001*. These figures exclude credit unions. More recent figures are expected shortly.

- **general service societies** include insurance and superannuation societies; those which promote co-operation in industry, sports and social pursuits; and residents' societies which provide common services to residential blocks and estates

- **housing societies** include those which manage ex-local authority stock; those which provide sheltered accommodation; and self-build societies[36]

SUMMARY OF 2000 ANNUAL RETURNS, INDUSTRIAL & PROVIDENT SOCIETIES

Category	Number of societies	Number of members 000's	Members' funds† £m	Total assets £m
Retail	95	5,827	1,637	3,637
Wholesale	90	286	831	2,661
Agricultural	817	1,101	230	601
Fishing	69	5	15	42
Clubs	3,291	2,224	370	547
General service	991	632	2,122	26,460
Housing	3,029	166	9,170	27,336
Total	8,382	10,241	14,375	61,284

Source: *Annual report of the Registry of Friendly Societies 2000-2001, Table 1.5 (credit unions excluded)*

† Comprises share capital, deposits and loans from members and reserves

New societies continue to be formed but there are also regular removals from the register, both as a result of requests from a society for its registration to be cancelled and after action initiated by the registration authority. As at 31 March 2002, some 8,293 industrial and provident societies were on the FSA's register (excluding credit unions).[37] In addition, a further 1,979 non-friendly societies were registered under the *Friendly Societies Act 1974*.

III Legislative reform

A. Treasury consultation

Although the legislation on industrial and provident societies has been reformed and consolidated over the years, the underlying framework was developed in the nineteenth century. In March 1998, the Treasury consulted on proposals to introduce a new Industrial and Provident Societies Act, observing that the legislation had not kept pace with the framework of company law.[38]

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36 This account is based on Appendix A, *Annual report of the Registry of Friendly Societies 2000-2001*

37 Financial Services Authority, *Reporting on mutual societies under the single regulator*, June 2002

38 *Consultation Paper on proposals for a new Industrial & Provident Societies Act*, A consultation document issued by HM Treasury and the Registry of Friendly Societies, March 1998

Its consultation paper followed the publication of the UK Co-operative Council's draft Bill to modernise the law which applies to co-operatives. The Treasury explained that it broadly supported the thrust of those proposals but added that it saw advantages in updating the legislation so that reforms could apply to all types of industrial and provident societies not just co-operatives.

The consultation paper made a number of suggestions, not all of which were spelt out in detail. Key measures included:

- a change to registration procedures At the moment societies are registered following the positive scrutiny of their rulebooks and registration documentation by the FSA (at the time, the Registry of Friendly Societies). The paper sought views on moving to a similar system to that used by companies. Under the *Companies Act 1985*, a company which wishes to be registered makes a statutory declaration that it has complied with the requirements for registration. The Registrar of Companies is then entitled to treat that declaration as evidence that the law's requirements have been complied with. The system puts a greater onus on the applicant to check its documents and eligibility. The consultation paper sought views on moving to either a compulsory or a voluntary system of declarations for societies.[39]

- statutory definition of eligible societies The 1965 Act specifies that only bona fide co-operatives or community benefit societies may be registered but does not define either. The paper proposed incorporating a definition of each type of society in the Act. The definition of co-operatives was to take account of the International Co-operative Alliance principles (see below).[40]

- application of a minimum framework of corporate governance With the aim of reducing the scope for conflicts of interest, the paper canvassed a range of governance issues including the composition of boards and the provision of information to members about the dealings of directors with the society. The application of the *Company Directors' Disqualification Act 1986* to societies was also to be clarified.

- enhancement of the registrar's powers Some new powers were thought desirable to give effect to other proposed changes (for example giving a power to amend a society's rules where they were incorrect would be desirable if societies could be registered by statutory declaration). Other powers were also mooted to give the registrar greater powers of intervention where a society was acting in breach of the law.

- additional procedures for winding up and dissolution Societies would be put in the same position as companies and would be subject to the same procedures. The

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39 Consultation paper, para 11 ff
40 Consultation paper, para 15 ff

possibility of allowing societies to impose restrictions on the treatment of their assets following solvent dissolution was also raised.

Some specific proposals from the consultation are discussed later in this paper in relation to the current Bill's proposals.

At the time of the consultation, the department said that it was being carried out with a view to updating the Act should a legislative slot become available: 'there can be no guarantee that this will happen in the near future'.[41]

This caution was well-placed. Asked by Andrew Love in March 2000 about submissions received during the consultation process and plans to bring forward legislation, Melanie Johnson as Economic Secretary to the Treasury said:

> The Government recognise the wish to modernise the Industrial and Provident Societies Acts. 76 written responses to the consultation document were received. They have not been published. Responses were received from the Movement's promoting bodies, other interested organisations and a number of individual industrial and provident societies, who made a number of wide ranging comments on the issues and questions raised in the consultation document. Discussions with the Movement are continuing.[42]

While the consultation may have formed the basis for discussions with the sector, the Treasury has not brought forward its own proposals on reforming the legislation nor published the results of the 1998 consultation process. Instead, limited changes to I & P legislation have been made through a Private Members' Bill promoted by Gareth Thomas (Harrow West). His *Industrial and Provident Societies Act 2002* is discussed below.

B. Industrial and Provident Societies Act 2002

Gareth Thomas (Harrow West) came seventh in the Private Members' ballot in 2001. His *Industrial and Provident Societies Bill 2001-02* aimed to protect the mutuality of industrial and provident societies and to update their legislation. As first introduced, the Bill had three aims:

- to make votes on proposals to convert from a society to a registered company, or to amalgamate with or transfer engagements to a registered company (i.e. demutualisation), subject to higher thresholds for member approval (in line with the position for building societies (clause 1)

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41 Ibid. para 1

42 HC Deb 20 March 2000 c446W

- to allow community benefit societies to include in their rules provisions that would ensure that the society's assets would remain either with the society or another organisation which exists to provide a community or public benefit (i.e. entrenchment or an asset-lock) (clause 2)

- to allow further assimilation between company law and the industrial and provident societies legislation to be carried out by order rather than primary legislation (clause 3)

a. Demutualisation thresholds

The first of these aims (a higher threshold for demutualisation votes) was quickly endorsed by the government at Second Reading and is now on the statute book:

> (Ruth Kelly, Economic Secretary) This is a useful modernisation measure that would bring the rules for such votes in industrial and provident societies into line with those for building societies. The Government fully support the clause.[43]

The proposal subsequently received the belated endorsement of the government's think-tank, the Strategy Unit which under its original name of the Performance and Innovation Unit was at the time of the debate reviewing the law on charities and the not-for-profit sector.[44]

b. Entrenchment or the asset lock

The second and third aims were more controversial. Taking the proposed asset lock first, this was not to apply to co-operatives but only to community benefit societies. At Second Reading Gareth Thomas explained that the Bill:

> would allow community benefit societies to choose to have similar protection in law as charities and to be free from the possibility that one group of activists in the organisation could attempt to use the organisation's assets for their own benefit rather than for their original established purpose, which is for the benefit of the community.[45]

He noted that from the *Industrial and Provident Societies Act 1965* it appeared that the assets of community benefit societies were protected from being distributed to members:

> such societies are not supposed to make distributions out of profits or surplus to members, and, on a solvent winding-up, assets should not be distributed to

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43 HC Deb 25 January 2002 c1162
44 Strategy Unit, para 5.37
45 HC Deb 25 January 2002 c1104

> members. However, the ability to convert or transfer engagements to a company under section 52 of the 1965 Act allows such restrictions to be avoided once the society is converted into a company and the shareholders could amend the rules that permit the distribution of assets to themselves. There is clearly a loophole in the legislation, which the Bill attempts to address.[46]

He proposed that societies should be allowed to vote to alter their rules so as to dedicate permanently their assets to public or community benefit. This was to be achieved by permitting both new and existing societies to make sure that their assets always remain either in the society, or in an another community benefit society or a charity if the society were to convert or sell its business. Provision was also made to allow the assets to be passed to a company (which would have to have had similar rules on the treatment of its assets).

The Minister described herself as 'very sympathetic to the thinking behind the measure' but expressed some concerns about whether such a provision should be made available to all societies in the sector, and whether the rule could have undesirable consequences.[47] In particular, she questioned whether the proposal was sufficiently flexible:

> (Ruth Kelly) …. locking in a society's assets could restrict the flexibility afforded to the bencom if it were struggling. It is conceivable that a society could in good faith choose at its inception to lock in its assets in perpetuity but then run into trouble and not find another industrial and provident society in a fit state or willing to take it over. It is not clear how that dilemma could be resolved under the clause.[48]

She also referred to the work of the Performance and Innovation Unit (now the Strategy Unit) which was then reviewing law in the charitable and voluntary sector and which might address the issue. Although the government resisted the clause as it stood, she left the door open for further discussions as to how it might be made acceptable.

In Committee, the availability of an asset lock was subjected to further scrutiny. Several Members raised concerns about whether such a lock-in would be appropriate in all circumstances. Christopher Chope tabled, but withdrew, an amendment which would have restricted the availability of the statutory lock-in provision to new societies only. While expressing reservations about the wording of that amendment, the Minister noted that if a society were to adopt a lock-in after formation human rights issues might be engaged since any members who did not favour the adoption of a lock-in clause would be

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46 HC Deb 25 January 2002 c1104
47 HC Deb 25 January 2002 c1162
48 HC Deb 25 January 2002 c1162

being deprived of potential property rights.[49] Mr Thomas undertook to examine the points that had been raised and if necessary to bring forward amendments.[50]

More substantial disagreement arose in relation to the provisions that once a lock-in provision had been incorporated into a society's rules, it could not subsequently be removed (c.2(1)(b)) and that a society could not convert or pass its engagements to a company unless the company had an equivalent lock-in provision. Mr Chope said:

> No Parliament can bind its successors, so why should one group of members of a community benefit society be able to bind its successors for all time, and curtail their freedom of choice to reach a different view? If the regulator or the registrar adopts a policy on public interest grounds, he—or a subsequent regulator or registrar—can change it. That must also be the case with regard to members of a society: they should be able to reach a different conclusion in different circumstances that we might not be able to foresee now. That is why I am concerned about the entrenchment provision in paragraph (b).
>
> Paragraph (c) is the most severely restrictive part of the clause, because it restricts flexibility and undermines a provision in the Industrial and Provident Societies Act 1965. It entrenches assets, and that is unacceptable…[51]

The Minister acknowledged the advantages of the clause for the sector but urged careful consideration of its effects. She was cautious about the possibility of an equivalent entrenchment provision for companies (which would be needed if engagements were to be transferable to a company). She also asked whether such a provision should be completely irreversible: if it should be reversible in some circumstances, she asked what body might appropriately be given powers to intervene and under what conditions.[52]

Mr Thomas said that he recognised that the clause raised issues which still required resolution. He agreed to consider the comments of Mr Chope and the Minister with a view to tabling amendments on Report or recognising that 'another legislative opportunity might be more appropriate for such changes'.[53]

At Third Reading, Mr Thomas brought forward amendments which removed his entrenchment proposal from the Bill:

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49 SC Deb (G) 13 February 2002 c8

50 Ibid. c9

51 Ibid. cc9-10

52 A comparison with charity law may be appropriate. Funds once devoted to charity must remain in the charitable sector. The courts and the Charity Commission have powers to devise schemes of arrangement for defunct charities and to apply gifts which cannot be passed to the intended recipient ('cy-près') for related purposes.

53 SC Deb (G) 13 February 2002 c11

> I do so with some reluctance – but I feel reassured that the issues will not drop off the agenda, and I am delighted by the work being done within Government. It is sensible that the issued raised […] should be considered as part of that discussion rather than remaining in the Bill.[54]

His reference to work being done in Government was to the Performance and Innovation Unit (now the Strategy Unit: see below).

c. Modernising I & P law

When first introduced, the Bill contained a general power to alter industrial and provident society legislation to bring it back into line with company law (which has been updated more regularly).

Despite the fact that company law has been regularly adjusted over the years, the current Government decided that substantial reforms were necessary to bring company law itself up to date. It set up the Company Law Review in March 1998 which after lengthy consultation produced final recommendations in July 2001.[55] The Government subsequently issued a company law white paper for consultation, with the aim of producing a new Companies Act in due course. When the Company Law Review was set up, ministers noted that it was to be the first fundamental overhaul of company law since its development by the Victorians.

I & P law, which has been less revised, retains even more of its Victorian heritage. The Co-operative Commission in early 2001 called for a similar approach to that adopted for the Company Law Review to be used to develop a simple, modern, efficient and cost-effective legal framework for the social enterprise and mutual sectors.[56]

Gareth Thomas' Bill initially proposed granting a broad order-making power to the Treasury which could be used for the purpose of assimilating industrial and provident society law with company law. Some core parts of the I & P legislation were to be excluded from the order-making power. Orders made under the clause were to be subject to affirmative approval by both Houses of Parliament.

At Second Reading, Christopher Chope spoke of his difficulties with the clause:

> I have a principled objection to clause 3. It would enable the Government to impose company law provisions that do not currently apply to industrial and provident societies, by means of an unamendable statutory instrument. It would enable not only existing company law, but company law as it might become at

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54 HC Deb 19 April 2002 c837

55 Company Law Review Steering Group, *Final Report*, Department of Trade and Industry, July 2001, 2 vols

56 Co-operative Commission, rec 50

> any stage in future, to be imposed without effective parliamentary scrutiny. An extensive legislative shake-up of company law is imminent. The effect of the clause would be that company law could be amended in a Bill confined to companies, and later applied to industrial and provident societies without the same scrutiny.[57]

He argued that the problem of out-dated I & P legislation should instead be addressed by bringing industrial and provident societies within the long title of future companies legislation, so that Parliament would have the opportunity to debate new provisions.

While the Minister was able to 'strongly support the principle of levelling the playing field' she was similarly wary of the scope of the clause:

> the clause as currently drafted gives significantly broader powers to the Treasury than do corresponding provisions in [building society and friendly society legislation], a point recognised by the hon. Member for Christchurch [Christopher Chope]. Therefore, although we are prepared to support the clause in principle, we want it to be amended so that it is brought into line with other legislation, particularly that on building societies. I believe that if we made that sort of amendment we would have an appropriate constraint in place.[58]

In Committee, Mr Thomas brought forward a new clause which constrained the order-making power by specifying areas for which it could be used. Among the areas specified were changes to the effect of the *ultra vires* rule on society transactions with third parties; permitting documents to be authenticated by signature as well as seal; the clarification of rules on undesirable names for societies; accountability requirements for transactions with society directors; powers to allow inspectors to be appointed on the regulator's own initiative; updating auditing and accounting requirements and exemptions for societies; and the extension of the availability of certain corporate insolvency procedures.

Mr Thomas said:

> There is nothing in the list of provisions set out in new clause 5 that is radically different from anything in existing company law. Radical change to the rules and regulations under which I and P societies operate is not possible under a statutory instrument delivered under this clause. The net effect of the differences between I and P law and company law in the eight areas is that the legal form of I and Ps is significantly out of date and problematic.[59]

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57 HC Deb 25 January 2002 c1150
58 HC Deb 25 January 2002 c1163
59 SC Deb (G) 13 February 2002 c15

The new clause did not receive the endorsement of Mr Chope, who was concerned about the ability to introduce new criminal offences under it, a concern which the minister did not share. However, the minister was still unable to accept the clause.[60]

At Report Stage, a further new version of the clause was tabled by Mr Thomas. It specified areas for which the order-making power could not be used: those which are central to the character of an industrial and provident society. Subject to the excepted areas, the order-making power would be available to bring I & P law into line with company law but only when company law itself in that area was being changed. In other words, the power would be restricted to areas of company law that were themselves being modified. In this revised form, the clause was accepted.

d. Fees

A number of other issues were raised during the proceedings on the Bill. Those which overlap with the current Bill are discussed below in Part IV of the paper. However one issue which was debated at length and formed the subject of several unsuccessful amendments to the 2001-2002 Bill was that of regulatory fees.

Since December 2001, the regulator for I & P societies has been the Financial Services Authority (FSA). Unlike the predecessor regulator, the Registry of Friendly Societies, the FSA does not receive government subsidy for any of the costs of regulation. Instead, its costs are recovered in full from the regulated community. As part of its initial fee structure, the FSA proposed a flat annual fee for I & P societies with no additional charges for additional assistance from the regulator. This was to replace the previous fee arrangements under which a small annual registration fee had been payable, but additional fees were charged for transactions which required regulatory approval (such as the adoption of new rules by a society). As a consequence, very small societies would have seen their annual fees increasing tenfold from £25 to around £240.

The effect of the proposed fee structure on local WI country markets, for example, for whom the new fee would have been uneconomic was highlighted in an effective campaign. As a result of the debates in the House, and a meeting between the FSA and Mr Thomas and Mr Chope, the FSA delayed setting the fees for these societies pending further consultation. It later brought forward new proposals which involve a banded fee scale, related to a society's assets.[61] The smallest societies will now pay £60 for 2002-03, compared with the £240 originally proposed. WI Country Markets has expressed its gratitude to Members of Parliament for their help in securing this change.

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60 SC Deb (G) 13 February 2002 c23

61 *Feedback statement on fees review*, Financial Services Authority, August 2002

C. Strategy Unit report

The Prime Minister announced in July 2001 a review of the regulation and law that applies to the charitable and not-for-profit sector. It was to be a wide-ranging review, which included in its scope the possibility of revising the boundaries of charitable status (largely settled in 1601) and making recommendations on suitable forms for not-for-profit organisations. After some delays, the final report, *Private Action, Public Benefit,* was published in September 2002.[62] In its foreword, the Prime Minister wrote: 'there is … insufficient recognition in the legal system of the particular needs of social enterprises, a rapidly growing group of businesses carrying out a wide range of activities for the benefit of society rather than the individual.'[63]

During the proceedings on the *Industrial and Provident Societies Act 2002,* the deliberations of the Strategy Unit were several times referred to, most notably in the context of how an asset-lock could be introduced for community benefit societies. Now that it has reported, the Unit's recommendations support the concept of entrenchment and the modernisation of industrial and provident society law, both of which are a feature of the current *Co-operative and Community Benefit Societies Bill 2002-03*. This support is expected to give these elements of the Bill a stronger chance of success than before.

The Strategy Unit recommends reforms to the legal frameworks available for not-for-profit organisations including charities. It is worth noting at this point that a charity is not an organisational structure: charities take a number of forms, including companies limited by guarantee, industrial and provident societies, unincorporated associations and trusts. Charitable status is an additional status to which organisations which take these forms may be entitled if they meet the legal test for being charitable. The I & P society form is currently used by both charitable and non-charitable organisations.

The Strategy Unit considers charities and social enterprises separately in its discussion of organisational forms. For charities that wish to incorporate, it recommends that a new form, the 'charitable incorporated organisation' be devised. This is designed to address the current situation in which charitable companies are to some extent subject to regulation both as a company and as a charity. It points out in particular the misalignment that can occur when a charity is registered as a company limited by guarantee, which despite its special characteristics is derived from the standard company form which assumes that its members are associating because of their financial interests. The Unit makes fewer explicit criticisms of the I & P society form as a charity vehicle (community benefit societies are not profit-centred) but the points about dual regulation and non-charity specific design still apply.[64]

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62 Strategy Unit, *Private Action, Public Benefit: A review of charities and the wider not-for-profit sector,* September 2002 ('Strategy Unit')

63 Strategy Unit, foreword

64 Strategy Unit, *Private Action, Public Benefit: Charitable Incorporate Organisation*, September 2002. This is a consultation document issued with the main report.

For social enterprises, by which it means organisations which trade in order to build long-term sustainability, but which operate for a social purpose and use their profits to that end, the Unit recommends two forms: a modernised I & P society form and a new vehicle, the community interest company (CIC).

The report notes that the distinctive aims of social enterprises require different governance structures from conventional companies:

> 5.10 The aims of social enteprises are social, rather than to make profits for owners. What they do falls between the charitable and the commercial - a middle ground which is, at present, poorly recognised. Formal governance structures, and lines of accountability, are less clear-cut than for the public or private sectors, often involving a wide range of stakeholders. Many social enterprises, for instance, are ultimately accountable to their users, members or staff, rather than – as is the norm with most private companies – their providers of capital. And since social enterprises usually re-invest any surplus they make in their business, rather than distributing it to the owners of the organisation, conventional equity is often not an appropriate form of financing.
>
> 5.11 The forms of incorporation available to these enterprises must therefore recognise their fundamentally distinctive ethos, whilst remaining flexible enough to apply to a very wide range of organisational styles and structures.[65]

It highlights some perceived problems with the industrial and provident society form (and that of the company limited by guarantee) when used by social enterprises:

- **Lack of protection of assets** the members are able to vote to demutualise and share the proceeds or the assets
- **Weak brand and poor recognition** the I & P society form is not well understood and its legislation has fallen behind company law
- **Difficulties in raising finance** the causes include limits on the amount of equity an individual member can hold and increased costs of raising funds because of the unfamiliar form
- **Expense of registration** the process of registering an I & P society is more complex and expensive than company registration[66]

To address these problems, the report calls for modernisation of the I & P form, which it said is a 'useful, but under-used and outdated, legal form'.[67] It recommends that

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65 Strategy Unit, paras 5.10-11
66 See Strategy Unit, Box 5.1
67 Strategy Unit, para 5.33

- the umbrella term 'industrial and provident society' should be replaced by the names of the two types of society: 'co-operatives and community benefit societies'.[68]
- bona fide co-operatives be given a statutory definition modelled on the International Co-operative Alliance's statement.[69]
- community benefit societies be allowed to have different categories of members (e.g. staff and users, but that voting should not be in proportion to their capital stake)
- members of community benefit societies should be able to vote to protect their assets in perpetuity through an asset lock[70]
- constraints on financing should be relaxed
- the threshold for demutualising or dissolving societies should be raised to the same level as in building societies[71]
- industrial and provident society legislation should be brought up to date with relevant aspects of company legislation, and future updating should made be possible by secondary legislation[72]

The Unit notes that consultation would be required on some of the more technical issues that arise from these recommendations.

The new community interest company (CIC) would be an alternative choice for social enterprises if the Unit's recommendation is taken up. The CIC would also contain an asset lock. Its objects would have to be in the 'public and community interest' and it would be subject to increased transparency and accountability requirements. It is proposed that two forms would be available, one limited by shares (and subject to mainstream company law), the other by guarantee. Both would be able to raise funds by issuing fixed-rate preference shares.

The Strategy Unit's report was formally out for consultation until the end of December 2002, in a joint consultation exercise by the Home Office and the Unit.

D. Enterprise Act 2002

While the *Industrial and Provident Societies Bill 2001-02* was in the House of Lords, having successfully passed through the Commons, Gareth Thomas tabled amendments to

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68 Mark Todd has used these terms for the title of his Bill.

69 The statement is reproduced at the end of this paper.

70 This measure is contained in the current Bill.

71 This was achieved by Gareth Thomas' Bill. The recommendation presumably pre-dates that Bill's grant of Royal Assent.

72 The current Bill proposes some modernisation of I & P society law. Gareth Thomas' Bill already allows I & P law to be updated in line with company law when modifications are being made to those aspects of company law.

the *Enterprise Bill 2001-02* in Committee. The new clause, which was added to the Bill, allows the Treasury and the DTI to extend by regulations the regime for administration orders and company voluntary arrangements to industrial and provident societies and friendly societies.[73] Companies have had recourse to these voluntary insolvency mechanisms since 1986 but industrial and provident societies which have found themselves in financial difficulties have not been able to take advantage of them. This has made it hard to rescue the business of I & P societies that are in financial difficulties. The new power is similar in kind to the enabling powers contained in the *Industrial and Provident Societies Act 2002*.

IV The Bill

Mark Todd's Bill contains three measures:

- it would allow community benefit societies to include in their rules provisions that would ensure that the society's assets would remain either with the society or another organisation which exists to provide a community or public benefit (clause 1)

- it would bring the application of the *ultra vires* rule for societies into line with the current rules for companies. This would provide protection for those who do business with I & P societies while leaving protections for the company and its members (clause 2)

- it would change the current restrictive requirements on the use of the corporate seal by I & P societies. Instead the rules which apply for companies, where a corporate seal is no longer necessary for a company to execute documents, would be extended to societies (clause 3)

1. Clause 1: Community benefit societies

The distinction between community benefit societies and co-operative societies has been set out earlier in this paper. Clause 1 proposes an important change for those societies which are registered as community benefit societies. The Bill would:

> give community benefit societies the right to safeguard their assets in their constitutions and ensure that they are only used to benefit the community that they were set up to help. The lack of this protection prevents the use of mutuals in controlling a public service, forcing the use of company frameworks only.[74]

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[73] See section 255 of the *Enterprise Act 2002*

[74] Mark Todd, 17 December 2002 in a letter to sponsoring organisations for industrial and provident societies.

The clause would allow new societies (and existing societies which pass a special resolution) to make sure that their assets always remain either in the society, or pass to another body whose constitution prevents the assets being distributed. This entrenchment or asset lock would be spelt out in the society's constitution. It would prohibit the society's assets being distributed to its members. Assets could only be distributed when the society is dissolved, and in those circumstances they could only be given either to another community benefit society which itself has an asset lock in place, or to a charity. Charitable funds are already entrenched by law.

Because industrial and provident society law allows societies to demutualise and become a limited company, special protections need to be adopted to protect the assets if this happens. Societies which wish to establish an asset lock would include provisions in their constitutions that would prohibit the transfer of assets to limited companies except where the company in question has an asset lock in place.[75]

The members of a community benefit society would not be able to remove an asset lock once it is in place.

Asset locks will not apply automatically to community benefit societies. They will only apply where a society is either formed with an asset lock in place, or where a special resolution is passed by the members to introduce an asset lock. A special resolution requires two votes to be passed. On the first, a turnout of at least 50 per cent of the society's members is needed; 75 per cent of those voting must vote in favour. At the second, which takes place after an interval of at least 14 days, a simple majority of those voting is required. These thresholds, which reflect those for demutualisation, mean that a decision to introduce an asset lock must reflect the settled view of a substantial majority of the society's members.

It is worth setting out why an asset-lock might be required since at first sight it might appear unnecessary. It is normal practice today for the registration authority to require that community benefit societies include in their rules a provision that neither the assets of the society nor its profits may be distributed to members. The expectation is that any profits will either be ploughed back into the society to develop its business or that they will be used for another purpose similar to the society's main object (such as philanthropic or charitable purposes). This accords with the principle for which community benefit societies are registered, that their business exists not primarily for those who are members of the society, but for the interests of society at large. It is also normal for the rules to provide that on dissolution the assets must not be distributed to the

[75] Permanent asset locks at limited companies are probably not currently available but will be if the community interest company model, recommended by the Strategy Unit, is brought forward.

members either. Instead the rules must provide for the assets to be transferred to another named body with similar aims, or to a body with charitable or philanthropic purposes.[76]

Societies may be vulnerable to asset-stripping under the legislation as it stands, particularly where the society's own rules are unclear or silent as to how the assets are to be treated. There is a particular danger if a society converts to a company (since that process will not trigger any provisions in the rules as to the treatment of assets on dissolution). If a society converts to a company, it will then be open for the members of the society to alter its rules and permit distributions to members. In other words, the ability of I & Ps to demutualise provides a means of bypassing the apparent bar on distributing assets to society members.

The Government has in the past resisted attempts to entrench assets in the co-operative sector. However, supporters of the Bill have argued that a different approach is appropriate for community benefit societies. The rules of such societies are clearly shaped by the principle that the assets should never pass to the members. Indeed it is argued that the current position in which the law appears to allow assets to be diverted to members if a society converts are a loophole, and an unintended consequence of the legislation which originally created the community benefit class of industrial and provident society in the 1930s.

There are public policy arguments which can be made about the undesirability of allowing assets to be locked up in what may be unproductive use. Such a principle lies behind the rules against perpetuity in private trusts, for example.[77] However, that principle does not apply to public trusts (charities) where the rule instead is that once funds are devoted to charity they must remain in the charitable sector.

An example of entrenchment can also be found in the credit union sector. Credit unions are registered under the 1965 Act as industrial and provident societies but are subject to a regulatory framework which is set out in the *Credit Unions Act 1979*. Section 22 of that Act disapplies s.52 of the 1965 Act from credit unions and means they are not permitted to demutualise.

As the section on the *Industrial and Provident Societies Act 2002* above explains, that Act originally proposed an asset lock in similar terms to this clause. A number of objections were then raised to the possible adverse effect of such a lock. Since then, a government think-tank has recommended that as part of a series of reforms to industrial and provident society law, community benefit societies should be permitted to entrench their assets through an asset lock:

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[76] *Information on the registration of Benefit of the Community Societies under the Industrial and Provident Societies Act 1965*, FSA Mutual Societies Registration information note.

[77] This complicated rule requires that transfers of property must take effect within specified periods; indefinite future interests, which do not allow the asset to be dealt with, cannot be created.

> 5.15 In the case of I&PSs, increased protection of assets is proposed. Community Benefit Societies should have the option of locking their assets irrevocably to certain social objectives (this is inappropriate for Co-operatives, being purely member benefit organisations). An irrevocable lock is also proposed for all Community Interest Companies.
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> 5.16 By making it possible for organisations which are not charities to protect their assets in law in this way, these changes will pave the way for growth in the sector. The protection of assets – alongside the limits on profit-sharing which are already present in one type of I&PS, and which are envisaged for the Community Interest Company - will prevent private individuals from profiting from organisations set up to serve a wider purpose. It will also give funders, such as charitable trusts and government agencies, greater confidence that their money will be used for the purpose for which it was given.
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> 5.17 The purpose of the lock on assets is not to protect the organisation itself from change or take-over. That would risk shielding inefficiency. It is the assets, not the organisation using them, that would be protected. So an organisation could be taken over – but the proceeds from the transaction would have to be distributed to another organisation to be used for a similar purpose. Robust mechanisms would have to be put in place to ensure that takeovers, mergers and dissolutions are conducted in a fair and transparent way.
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> 5.18 Similarly, it would be counter to the whole ethos of the sector if an organisation, once set up, could never evolve and change its purposes and activities. It is envisaged that such changes would be made as easy as possible – so long as the new purposes were still ones which fulfilled public or member interests.[78]

In another context, the government's controversial proposals on foundation hospitals contain plans for an asset lock. The governance arrangements for these hospitals have reportedly been modelled on co-operative and mutual organisations.[79]

This Research Paper has referred to a number of sectors in which mutual bodies seem likely to play an increasing role, notably the provision of community and public services and the holding of assets for the delivery of such services. Supporters of the Bill argue that the legislation as it stands, in addition to an awareness of the general phenomenon of demutualisation, acts as a barrier to the willingness of organisations to set up industrial and provident societies with formerly public assets.

Although the government did not feel able to accept an asset lock during the progress of the *Industrial and Provident Societies Act 2002*, in the light of the Strategy Unit report it

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78 Strategy Unit, paras 5.15-18 and see also para 5.37

79 Department of Health, *A guide to NHS foundation trusts*, December 2002, para 1.24

seems more probable that it will do so now. However, it is possible that some technical issues relating to how assets would be applied when a society dissolves may require further thought.

2. Clause 2: Capacity

Companies are legal fictions which have the power to carry out only those activities which are authorised by their constitutions. The main source of a company's capacity is set out in the 'objects clause' of its memorandum. Actions which fall outside the scope of the memorandum are '*ultra vires*' or beyond the company's capacity. In addition, as a legal person rather than a natural person, a company can in practice act only through agents such as its directors, officers and managers. The company's constitution will specify what powers its directors have to make agreements on its behalf. It may also contain specific restrictions on the powers of officers and directors to bind the company.

There is therefore a risk that third parties who deal with a company may be making contracts which are either outside the company's capacity or beyond the authority of the agent with whom they are dealing. In theory such contracts could be unenforceable against the company. However, this once fertile area of company law is considerably less important than it used to be thanks to various statutory changes which protect the interests of third parties when they deal with companies that act beyond their capacity. Companies are also permitted to regularise *ultra vires* actions (subject to some protections for members of the company).

In particular, section 35 of the *Companies Act 1985* provides that the validity of an act done by a company shall not be called into question on the grounds of a lack of capacity by reason of anything in the company's memorandum; section 35A provides that a person who deals with a company in good faith can assume (without needing to enquire into the company's constitution) that the directors are entitled to bind the company and authorise others to do so; section 35B provides that there is no duty on a party to a transaction to enquire into whether the transaction is permitted by the company's memorandum or whether there is any limitation on the directors' powers. These sections are designed to protect outsiders to the company. Directors are still expected to observe the constitutional limitations in the memorandum and shareholders may sometimes be able to take action to restrain an *ultra vires* act by their company. There are rules to ensure directors and those connected with them do not benefit from these protections when they transact with the company (unless the company chooses to allow them to) (s.322A).

In their current form, the above provisions for companies derive from the *Companies Act 1989*'s amendments to the *Companies Act 1985*. Industrial and provident societies, however, are still covered by the *ultra vires* rule. The Treasury's consultation in 1998 discussed reforming its application:

> 21. The legal capacity of societies in dealing with third parties is at present much restricted by the "ultra vires" rule. A society does not have any capacity to act as

> a legal person outside the powers and objects stated in its objects rule. This leaves those dealing with societies open to the risk that transactions may be invalid as being outside the society's objects.
>
> 22. This aspect of the ultra vires rule no longer applies to companies, following enactment of the Companies Act 1989. There seems no reason why societies should not have an equivalent legal capacity to deal with others. So it is proposed to cease to apply this aspect of the rule to societies. A provision similar to section 35 Companies Act 1985 (as substituted by the Companies Act 1989) could be introduced to effect this change.
>
> 23. It is proposed that other aspects of the ultra vires rule should continue to apply to societies as they do to companies. So the liabilities of directors and officials of a society for exceeding their powers, and a member's right to seek to restrain an act in terms similar to those applicable in the case of ultra vires acts, would be retained. Any new legislation would provide that certain transactions between directors, officers, or their associates and the society would be denied the protection enjoyed by transactions with outsiders.[80]

Clause 2 applies sections 35, 35A, 35B and 322A of the *Companies Act 1985* to societies as if societies were companies. The clause makes additional adjustments to allow those sections to have the desired effect on societies, including setting out the majorities for special resolutions (which can be used to relieve the liability of directors when they act beyond their authority).

Andrew Love tabled but withdrew an amendment in similar terms (but without the additional adjustments) during the Committee stage of the *Industrial and Provident Societies Act 2002*.[81]

3. Clause 3: Corporate seal

Under the common law documents are executed by companies using the common seal, an authenticating stamp. In practice, companies are now no longer required to have a corporate seal, and any documents which used to require the use of the seal may instead be executed either with the seal or by being signed by two directors or one director and the secretary. The formalities for executing documents at industrial and provident societies still require the use of the seal which can prove onerous when many documents need to be executed. However, it has been argued that the requirement to use a seal is a valuable protection against possible wrongdoing.[82]

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[80] HM Treasury, *Consultation Paper on proposals for a new Industrial & Provident Societies Act*, A consultation document issued by HM Treasury and the Registry of Friendly Societies, March 1998

[81] SC Deb (G) 13 February 2002 cc28-9

[82] Law Commission, *The Execution of deeds and documents by or on behalf of bodies corporate*, Law Com 253/ Cm 4026, 26 August 1998, para 4.12 and footnote 16

The clause would bring I & P societies into line with the situation at limited companies. It applies the relevant sections of the *Companies Act 1985* to societies as if they were companies: in particular s.36 (contracts can be made using a seal or by a person acting on the company's authority); and s.36A (documents can be executed by seal or signatures; purchasers in good faith are protected if a document purports to have been executed by the company).[83] Under s.36C, if a contract is made before a company is incorporated on its behalf, the person claiming to act for the company is made personally liable for the contract unless other provision is made.[84] The clause also makes consequential amendments to I & P legislation.

Andrew Love had proposed a similar amendment to the *Industrial and Provident Societies Act 2002* in Committee.[85] The government declared itself in sympathy with the aims of the new clauses but wished to consider their implications further.[86]

V Reaction to the Bill

The Bill has not been widely discussed in the press but it is backed by the Co-operative Party which has been a driver for change in industrial and provident society law . A press release from the Co-operative Party urges its members to support the Bill. Peter Hunt, national secretary, said:

> "Once again I urge co-operators to write to their MPs, encouraging them to vote in support of the Bill and requesting that they write to Gordon Brown to ensure Treasury support. Party staff will be doing all they can to help, and we will be assembling a coalition of support including Co-operative Societies, Party Councils and other mutual organisations to ensure that the Government realises the entire co-operative and mutual sector is united around these important measures".[87]

The *Industrial and Provident Societies Act 2002* benefited from all party support when it passed through the House, despite some specific concerns about some of its proposals.

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83 Separate provision is made for Scotland.

84 Other sections that are applied by this clause provide for the authentification by a society of documents and the use of additional seals abroad by authorised agents.

85 SC Deb (G) 13 February 2002 c28

86 SC Deb (G) 13 February 2002 c30

87 Co-operative Party press release, *New Bill promises further improvement to Co-op law*, 4 December 2002

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Appendix: Statement on the Co-Operative Identity

The 1995 International Co-operative Alliance Centennial Congress held in Manchester adopted the following Statement on the Co-operative Identity:

Definition

A co-operative 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.

Values

Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.

Principles

The Co-operative principles are guidelines by which co-operatives put their values into practice.

1st Principle : Voluntary and Open Membership

Co-operatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, or religious discrimination.

2nd Principle: Democratic Member Control

Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote), and co-operatives at other levels are also organised in a democratic manner.

3rd Principle: Member Economic Participation

Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least

would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.

4th Principle: Autonomy and Independence

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.

5th Principle: Education, Training and Information

Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public - particularly young people and opinion leaders - about the nature and benefits of co-operation.

6th Principle: Co-operation Among Co-operatives

serve their members most effectively and strengthen the Co-operative Movement by working together through local, national, regional, and international structures.

7th Principle: Concern for Community

Co-operatives work for the sustainable development of their communities through policies approved by their members.

[Reproduced from *Consultation paper on proposals for a new Industrial & Provident Societies Act*, HM Treasury and Registry of Friendly Societies, March 1998]