Co-operative Capital Units (CCUs)

Tony Addison

Co-operative Capital Units ("CCUs") are a type of financial instrument intended to raise funds to finance the operations of co-operatives. They are peculiar to co-operatives and indeed are unique to New South Wales. They were introduced with the then new *Co-operatives Act* ("Act") in 1992.

A CCU is a flexible instrument which allows a co-operative, through member vote, to fix the terms of issue of CCUs along the lines of a debt instrument or a share or containing some elements of each.

Background History

As a co-operative's shares can only be issued to active members, CCUs were introduced to permit co-operatives to raise funds, outside of member share issues.

The Act was the result of the Blake/Dominguez review of the 1923 *Co-operation Act* ("1923 Act"). Their review recommended a number of reforms and the modernisation of many of the provisions in the 1923 Act.

One of the review's recommendations was for the introduction of CCUs as a form of capital contribution, to be not unlike redeemable preference shares. The specific recommendation was as follows:

"Recommendation (5) The Act should provide for-

(a) the traditional requirement for co-operative capital to be comprised solely of contributions by active members in proportion to transactions to be varied to permit the issue of "co-operative capital units" ("C.C.U.s");

(b) the possibility of risk capital becoming available to co-operatives through legal structures co-ordinated with and controlled by, but external to the co-operative itself, such as joint ventures (both incorporated and unincorporated), unit trust funds, and subsidiaries with some external capital participating in profits and assets in specific ways;

(c) a co-operative to be permitted to issue C.C.U.s having such rights as are specified in the rules or in a special resolution of members lodged on the public register on the following terms -

(i) C.C.U.s carry a right to one vote per share at meetings of that class of holders but otherwise are non-voting;

(ii) C.C.U.s may only be redeemed if fully paid up, and only out of profits available for dividend or a fresh issue of C.C.U.s or ordinary shares made for the purpose, or if redeemable at a premium, the premium on redemption may be provided for out of profits or out of the share premium accounts for shares or C.C.U.s;

(iii) the rights of the C.C.U.s may be varied in accordance with their terms of issue but only with the consent of three quarters of the holders given in writing or at a meeting;

(iv) unless the rules otherwise provide C.C.U.s may be freely transferable by proper instrument of transfer;

(v) a holder of C.C.U.s shall be deemed not to be a member of the co-operative but shall be bound by the rules of the co-operative to the extent that they apply to C.C.U.s and shall be entitled to a copy of each document sent to members of the co-operative."

The rationale advanced by Blake and Dominquez focused on the inability of co-operatives to meet their capital needs by either debt or the traditional members' equity. The introduction of the active membership requirements had further limited funding through share issues – as only those who actively used the services of the co-operative could be shareholders. The review noted that some co-operatives had turned to cognate structures of subsidiary companies and joint ventures as a means of conducting activities. In this way third party risk capital had been utilised in pursuing the co-operative's activities. In the light of these circumstances the review argued that the requirement for one class of share lost some of its logical force.

The review noted that any form of capital that mingled members' rights with those of any external risk takers would create tensions between the co-operators and the risk capital providers. There is the possibility of loss of control of the assets capitalised in this way because of the preferential rights necessarily granted. To deal with this problem the review argued as follows:

"In most cases, therefore, risk capital provided by non-members should be legally isolated from capital contributed by active members, and the main co-operative entity should be based solely on contributions and transactions by members, while external funding through associated vehicles should be facilitated.

If, however, a co-operative considers that it would be in its interest to have another class of equity capital in addition to active members' shares as a means of fund raising, we believe that co-operative principles would not be significantly impaired if such equity were permitted according to the terms usually required for redeemable preference shares of a company, except that such shares should not in any circumstances have a right to vote at general meetings or postal ballots of members. They should only have voting rights within their class."

On the basis of the Blake/Dominguez recommendations, CCUs were introduced into the legislation. There has been no material departure in the enacted legislative provisions from the principles recommended in the review.

There have been some amendments to the CCU provisions since the passing of the Act but these have been by way of clarification. In particular it was made plain that CCUs could rank before, with, or after active member shares on a winding-up.

Legislative Provisions

The current legislative provisions are in Division 2 of Part 10 (Funds), sections 269 to 277 of the Act.

A brief overview is as follows:

- A CCU is personal property and is an interest in the capital but not the share capital of a co-operative [s.269(1), (2)].

- On a winding up of a co-operative, the holder of a CCU is to rank for priority of payment in accordance with the terms of issue. It may rank equally with, or behind unsecured debts and may rank in priority to, equally with, or behind debts due to contributories [s.269A]. Note: Ordinarily the active shareholders would be the contributories.

- CCUs can be issued to members or non members [s.271].

- If a co-operative may issue CCUs, the rules that permit the issue must contain provisions to the effect of the following:

    1. each holder of a CCU is entitled to one vote only at a meeting of the holders of CCUs;

    2. the rights of the holders of CCUs may be varied only in accordance with their terms of issue and only with the consent of at least 75% of the holders of CCUs;

    3. the holder of a CCU has, in the person's capacity as such a holder, none of the rights or entitlements of a member of the co-operative;

    4. the holder of a CCU is entitled to receive notice of all meetings of the co-operative and all other documents in the same manner as the holder of a debenture of the co-operative [s.272].

- CCUs cannot be issued unless their terms are approved by a special resolution of the co-operative and by the Registrar [s.273(1)].

- The Registrar is not to approve the terms of an issue if they are in conflict with co-operative principles as prescribed in s.6 of the Act [s.273(4)].

- The terms of issue must specify the following (but this subsection does not limit the contents of the terms of issue):

    1. details of entitlement to repayment of capital;

    2. details of entitlement to participate in surplus assets and profits;

    3. details of entitlement to interest on capital (whether cumulative or non-cumulative interest);

4. details of how capital and interest on capital are to rank for priority of payment on a winding up [s.273(2)].

- In discharging their duties, it is proper for directors to take into account that the holders of CCUs have no members' rights [s.274].

- A redemption of CCUs is not a reduction in the share capital of a co-operative [s.275(1)].

Significant Aspects of CCUs

The Namoi Cotton Co-operative ("Namoi") experience shows that a holder of a CCU can have influence (by nominating some of the Directors) but no determinative say in the running of the co-operative (which remains with active member Directors) so that it can be used to raise funds from the general public without any loss of control of the co-operative.

The CCU is treated as a share for the ASX but not a share for the purpose of the tax legislation. Shares cannot be quoted in a public manner for an entity to qualify as a Co-operative Company. See section 117 of the *Income Tax Assessment Act 1936* (Cth).

The CCU can be structured so that a greater amount than the subscribed amount can be repaid on maturity.

The CCU can rank on winding up wherever the terms of issue specify it to rank.

It is suggested that there is considerable scope for co-operatives to issue various classes of CCUs to its members.

A co-operative could, for example, have a class of CCUs that meet the retirement needs of members so that they continue their association with their co-operative after they cease to be active members. The invested funds could be subscribed by a DIY Superannuation Fund.

There are many situations where persons who do not qualify for active membership but who have a close connection with a Co-operative may be prepared to put money into the Co-operative or a particular part of its business or its expanded business by way of an investment.

Thus any co-operative could have a class of CCUs that apply to persons involved in the member's business but are not qualified to be members:

Example: CCUs could be issued to employees, contract drivers, sharefarmers, deck hands, contractors, consultants or franchisees of a business run by the co-operative.

A CCU could be drafted in terms that it could be converted into a share on the happening of certain events eg winding up, conversion to a company etc.

CCUs could be used as a stepping stone to gain the minimum number of shares for membership where that minimum is set by the Rules at a level which, for the average Joe, would require savings over a period to reach it.

The active membership rules could be drafted to dove-tail in with the terms of issue of a class of CCU so that the holder of a CCU, if he carried out an activity that benefited the co-operative (and was a CCU holder for not less than a prescribed amount for a prescribed period), could become a member and convert that CCU into a share in the co-operative.

A CCU could be drafted so that it does not become repayable by the co-operative for a very long time (or ever) and a person who wants to do business with the co-operative could be required to acquire such a CCU as the ticket for doing business.

These are examples only. The possibilities are endless. The Directors of a co-operative would need to be clear about their objectives before deciding on the appropriate terms of issue of the class of CCUs contemplated.

They would need to be in control of a financially sound business and be able to demonstrate this in their disclosure documents to those invited to subscribe.

Seek Public Funds with an Issue of CCUs (but don't list)

When issued outside NSW a CCU may be subject to the disclosure provisions of the Commonwealth Corporations Act 2001 ("Corporations Act") which will mean a product disclosure statement ("PDS") may be required under the Corporations Act. Also, the continuous disclosure provisions of the Corporations Act may apply to a co-operative which issues CCUs to the public outside New South Wales.

I am aware of at least one rural co-operative which has issued CCUs to the public at large without listing the CCUs or providing disclosure under the Corporations Act. However, I understand that their offer was restricted to members of the public within NSW. However, disclosure would still have been required under the Act.

It would be my view that if a Board decides on a public issue of CCUs for its co-operative without listing, it would probably be worthwhile to make the issue Australia-wide and comply with the relevant provisions (including the relevant disclosure provisions) of the Co-operatives Act and Corporations Act.

Seek Public Funds with an Issue of Listed CCUs

Namoi now provides a good precedent for a co-operative which would like to go to the public with an issue of CCUs and have them listed on the ASX.

The Board of Namoi reviewed alternative capital restructures that would assist Namoi to strengthen its competitive position and grow the business to meet the future needs of growers. The Directors determined that their core objectives were:

1. remain controlled by cotton growers;

2. provide flexibility to raise equity capital as required;

3. allow members to recognise and realise the value of Namoi; and

4. create a dynamic and growing organisation with the ability to respond to competitive pressures.

After reviewing all of the capital restructures available in the light of these objectives, Namoi decided to remain a co-operative but to substitute for its existing shares on issue (which were cancelled) Namoi Capital Stock for each 1 Namoi Share cancelled plus further stock calculated on a loyalty factor.

At the same time as the Board announced the proposal (which was a Scheme of Arrangement under the Co-operatives Act) to members to vote upon by special postal ballot, they also announced that the Board intended to undertake a new issue of Namoi Capital Stock to the public at large and raise between $20 to $35 million.

My understanding is that the Namoi restructure has been successful and although there is some discounting of the price of the listed CCUs on the stock exchange, this in the view of the Directors of the co-operative is more than compensated for by the fact that the co-operative remains wholly in the control of the active members.

The only concession to the holders of Namoi Capital Stock which was made to the principle of complete active membership control was that it was agreed by members and accepted by Mr Justice Santow that the holders of Namoi Capital Stock could nominate (but not elect) two out of the seven directors who must be Non-Grower Directors.

Many (particularly the investing public) would say that having regard to the size and constitution of some co-operative Boards, that it is healthy to have a Board of no more than seven and to have almost a third of that Board non members.

Obviously, Namoi had a good story to tell when it came to issuing a prospectus.

It is interesting to note that the ASX permitted Namoi to include a 15% limit on the ownership of Namoi Capital Stock for a period of 5 years (plus a further 5 years) only if this was agreed by an ordinary resolution of members and also an ordinary resolution of holders of Namoi Capital Stock.

Having regard to the fact that the holder of Namoi Capital Stock has influence only but no determinative say in the affairs of the co-operative it could be argued that this restriction was a belt and braces approach and was unnecessary. However, the Directors of Namoi must have considered it to be an additional selling point to gain the approval of their members to the restructure in the first place.

Conclusion

It is quite disappointing that the NSW co-operative sector has only used CCUs to a very limited extent, given the wide range of circumstances where they could be used.

In about 1988/89 the Registry Officers of the States and Territories invited the co-operative sector to participate in a survey but unfortunately the response in favour of including the CCU provisions in the core consistent provisions of uniform legislation was not strong enough to cause anything to happen.

There have been no complaints, so far as I am aware, of any conflict between ASIC and the NSW Registry in respect of the issuing of CCUs, even across State boundaries.

I would have thought that if a need for CCUs can be demonstrated in any particular State, the Attorney-General of that State should entertain the adoption of the CCU provisions into that State's Co-operatives Act.

Tony Addison

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ADDISONS
COMMERCIAL LAWYERS

Level 12
60 Carrington Street
Sydney NSW 2000 Australia
Telephone: (02) 8915 1000
Fax: (02) 8916 2000