Distribution Options for Co-operatives

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This paper discusses the various ways in which a Co-operative may distribute its funds to its members, whether by way of a capital payment or an income payment in the hands of members.

For the purposes of this paper I am discussing here, a Co-operative with a sound business or businesses that make income profits or capital gains or both. I am not discussing Co-operatives who are financially stressed or deliberately run on a shoe string which might well never intend to make distributions to members. Such Co-operatives will be trading Co-operatives as opposed to non-trading Co-operatives. Trading Co-operatives are Co-operatives that make distributions to members.

The starting point is the third Co-operative principle contained in Section 6 of the *Co-operatives Act 1992 (NSW)* ("the Act").

Third Co-operative Principle

So far as is relevant here, the third Co-operative Principle states that members contribute equitably to the capital of the Co-operative and receive limited compensation, if any, on capital subscribed. That is to say limited dividends.

It further provides that surpluses may be allocated to members for any or all of the following purposes:

- developing the Co-operative (retaining surpluses, see Section 280;
- possibly by setting up reserves (part of which would be indivisible) (see Section 282(2) and Section 142);
- benefiting members in proportion to their transactions with the Co-operative (see Sections 153(4) and 282(1)); and
- supporting other activities approved by the members (see Section 281(2)).

I have added the references to sections of the Act appearing in brackets above.

Co-operatives Generally

Co-operatives throughout the world are based on the Co-operative Principles, including the third Co-operative Principle outlined above, which reflect the principles adopted by International Co-operative Alliance.

The Co-operative Principles remind us that the philosophy of co-operatives is for members to enjoy their rights as a member whilst they actively participate in the objectives or business of their Co-operative, but once they cease to participate they must lose their membership after a required period and have any share capital that they have subscribed to the Co-operative repaid to them.

Where the members supply goods to their Co-operative they expect to receive a competitive price for their goods supplied. Generally, members look for a co-operative premium or rebate because the Co-operative has eliminated the middleman or wholesaler where the Co-operative can sell directly to retailers. Particularly is this the case where the Co-operative value adds, that is for example, turns raw milk into yogurt, releases apples out of season by storing them in cold rooms until there is a greater demand and less supply.

Where members purchase goods from their Co-operative they expect to acquire those goods purchased at a discount because the Co-operative is able to bulk buy directly from manufacturers or importers and has eliminated the distributors and wholesalers of the manufacturers. That is the theory but not always the reality because large corporates buy direct from the manufacturer or importer and have equal or greater buying power than large co-operative stores.

SHARE CAPITAL

In the ordinary course, once members become inactive, after the expiration of a required period set out in the Rules (being not more than three years), the Directors must declare a member's membership cancelled and contemporaneously forfeit the member's shares.

There is then a period of twelve months grace for the Co-operative in which the member's paid up capital on the forfeited shares must be repaid. There is no scope under the Act for a member to receive more than their paid up share capital in respect of the forfeited shares. If a member was required to pay a premium on top of the nominal value of the member's shares when the shares were first allocated, then the member should also be repaid that premium (see Part 6 Division 4 of the Act in respect of cancellation of membership etc of inactive members).

Co-operative Capital Units

However, as you would all be aware, members can acquire co-operative capital units in the Co-operative provided that the Rules of a Co-operative permit the issue of co-operative capital units and the members and the Registrar have approved the terms of issue of the co-operative capital units.

It is quite possible for co-operative capital units to be issued with a term permitting the holder to receive a capital gain on the maturing of co-operative capital units. They could, for example, be tied to a consumer price index (see Part 10 Division 2 in respect of co-operative capital units).

Sale of Shares or Winding Up

Of course, what I have said does not apply where members decide to sell their Co-operative to a third party who offers to pay more than the nominal value of the shares. Obviously, in circumstances such as this, where there is a takeover or where the Co-operative voluntarily winds up or converts to a company, members will often receive more than the nominal value of their shares and so make a capital gain.

Before deciding to sell, convert to a company or wind up, members must weigh up the advantages of the capital gain against the ongoing price benefits of belonging to a Co-operative over a long term.

Bonus Shares

Also, it is possible for members to receive bonus shares where an asset of the Co-operative sells at a profit or an asset of the Co-operative has been valued at a greater value than that disclosed prior to the valuation in the books of the Co-operative. An issue of bonus shares in these circumstances:

- must be approved by a special resolution of the Co-operative;
- must be issued as fully paid shares;
- must be issued only in respect of fully paid up shares; and
- must not exceed 20% of the nominal value of the issued share capital during any twelve month period.

See Section 156 of the Act in respect of the issue of bonus shares in these circumstances.

Debentures and Deposits

The Act applies to the exclusion of the *Corporations Act* to shares in, CCUs issued by, debentures of or deposits with a Co-operative. Any other type of financial interest in a Co-operative will attract the provisions of the *Corporations Act* (see Section 9 of the Act in this respect).

Debentures in a Co-operative are traditionally never issued with a built in provision for a capital gain nor do deposits of funds with a Co-operative have a capital gain element as a rule.

Capital Gain on Shares – No. Capital Gain on CCUs – Yes

In summary there is no scope for members to make a capital gain on their shareholding in a Co-operative unless all shares in the Co-operative are sold, or the Co-operative is wound up or converts to a company. Of course individual members may make capital gains on their shares if sold to other active members. In practice, members are not willing to pay more than the nominal value unless the Co-operative is likely to convert to a company, be wound up or all shares are likely to be sold on a take over.

There is however scope for a member to make a capital gain on CCUs held in the Co-operative at the time the CCUs mature.

The above is a summary only of the possibilities for members of a Co-operative to receive a capital gain, through their economic interest in their Co-operative.

INCOME

We move now to consider the possibilities for Directors who wish to benefit their members out of surpluses by way of a dividend or a rebate or bonus shares paid out of surpluses, but not bonus shares paid out of a capital profit or as a result of a Directors' resolution to revalue an asset which we have already discussed.

The relevant part of the Act is Division 4 of Part 10 which is arguably an exclusive, all encompassing code setting out in full the ways in which the Directors may deal with the surpluses in a Co-operative.

Surplus

Surplus is defined in Section 5 as follows:

" surplus, in relation to a co-operative, means the excess of income over expenditure after making proper allowance for taxation expense, depreciation in value of the property of the co-operative and for future contingencies. "

The definition of surplus is wide enough to include a capital profit.

As far as I have been able to discover, the word "surplus" in relation to a Co-operative means exactly the same as "profit" in relation to a company incorporated under the *Corporations Act*.

Curiously, the regulations governing to the financial accounting for Co-operatives speak about "profit" and don't use the word "surplus", whereas Division 4 of Part 10 uses the word "surplus" throughout the Division and not the word "profit".

Retention of Profit

Section 280 provides that a Co-operative may resolve to retain all or any part of the surplus arising in any year from the business of the Co-operative to be applied for the benefit of the Co-operative.

In other words, there is no requirement for surpluses to be applied for the benefit of members and the Co-operative can build up "retained earnings" without making any distributions whatsoever to members year upon year if they so decide.

The Reserve Resolution Trap

Great care needs to be given to resolutions of a Co-operative in relation to retained earnings and a warning bell should be sounded whenever Directors are considering whether or not any part of retained earnings should be transferred into a reserve account. This is because Division 5 of Part 6 of the Act applicable to Co-operatives with a share capital provides former members with an entitlement in respect of a distribution from reserves that takes place within five years after the former member's membership was cancelled. The relevant provision entitling former members to distribution from reserves is contained in Section 142 of the Act.

If Directors wish to avoid a distribution to former members, the Directors should not transfer funds into a reserve. Directors need to be alert to the possibility that their accountant may unwittingly treat part of the Co-operative's retained earning as a reserve without having regard to Section 142.

It is interesting to note that Section 156, referred to earlier, which gives powers to Directors to issue bonus shares arising from a capital gain of the Co-operative does not speak of the bonus shares being issued out of a reserve and it seems quite possible for bonus shares issued pursuant to Section 156 to be issued out of retained earnings where an asset has been sold at a profit or an asset has been revalued without in fact creating a reserve which would have the result that there would be an obligation upon the Directors to include the participation of former members in the bonus share issue.

Charitable and Community Activities

Division 4 of Part 10 also prescribes in Section 281 that Co-operatives may apply any part of the surplus arising in any year from the business of the Co-operative for:

- any charitable purpose; or
- for supporting any activity approved by the Co-operative.

In both cases, the Rules of the Co-operative must authorise surpluses to be so applied and must in both cases limit the amount to a specified proportion of the surplus. Section 281 takes care of the Co-operatives that are set up for charitable or community purposes but it is suggested that all Co-operatives should have Rules which authorise the spending of surpluses on charities or community activities.

It is common sense to ensure that a Co-operative's Rules give the Directors the greatest flexibility possible even where the view is formed that a particular enabling Rule is not required.

Section 282 – The Core Provision

Section 282 is the centre piece of Division 4 of Part 10 and sets out the main alternatives for the distribution of surpluses or reserves. Note again there must be an authorising Rule already in the Rules of the Co-operative before a distribution of the kind mentioned in Section 282 can be made.

It is curious that Section 282(1) says that distributions of the kind listed can be paid out of **part** of the surpluses or reserves of the Co-operative. Apparently, Co-operatives should not exhaust the whole of their reserves by paying a rebate, a dividend or issuing bonus shares.

Note further that Section 282 makes no reference back to Section 142 which gives rights to former members where a distribution comes out of reserves. When the NSW Government inserted Division 5 of Part 6 (which includes Section 142) into the Act as a reaction to the Panfida / Dairy Farmers litigation in about 1990 it apparently did not consider it necessary to amend Section 282.

Notwithstanding this, the general view is that if a distribution comes out of a reserve of any kind, whether by way of a rebate on business done, a bonus share issue or by way of a dividend, then Section 142 applies to require that distribution to be made to former members within the last five years as well as current members, whereas if the rebate, bonus share issue or dividend is simply paid out of surplus in a particular year, or surpluses for more than one particular year or simply out of "retained earnings", former members within the last five years do not have a right to participate.

Rebates – Section 282(1)(a)

Let's discuss distribution to members as a rebate on business done – such a payment is generally determined by the Board at a Board Meeting and/or by members at a meeting of Members – often the Annual General Meeting.

Section 204 of the Act vests in the Board of Directors all the powers of the Co-operative that are not required by the Act or the Rules of the Co-operative to be exercised by the Co-operative in general meeting.

There does not appear to be any reason why such a Rule cannot authorise the Board to resolve to pay any rebate without reference to members.

Sometimes the Board would like the members to approve the rebate or approve the size of the rebate, provided that the rebate cannot be increased by resolution of members. The Board resolution needs to be carefully drafted to prevent members helping themselves to a greater rebate than is recommended by the Board.

Sometimes the Rules themselves provide that a rebate must be approved by the members at a general meeting, provided that the general meeting cannot increase the level of the rebate above the recommended level set by the Board. This can lead to the possibility, which is indeed rare, where the general meeting decides on a rebate which is less than the rebate set by the Board.

Generally speaking, the period chosen for measuring the business done set out in the Board resolution or Board recommendation is the immediate past financial year in circumstances where the Board or the general meeting is determining the rebate generally three or four months after the year closes.

It is of course obvious that if Directors wish to benefit active members to the exclusion of inactive members then a rebate based on business done is a way of achieving this result.

Rebates or Co-operative Premiums (which tax year)

Rebates are frequently paid in agricultural Co-operatives on the basis of business done in the prior financial year, the result of which is to give members a higher price for the supply of their agricultural goods after the close of the financial year in which the goods are supplied.

It is however possible in an agricultural Co-operative, where members supply agricultural goods throughout the year or throughout a season, for payments to be distributed progressively throughout such period as rebates or "Co-operative premiums" paid in the year of supply so that in effect the distribution is made on an ongoing basis during the financial year in question rather than looking back after the financial year is closed to determine the level of rebate.

Care should also be taken in respect of the payment of rebates where those payments may conflict with the provisions of other legislation, for example mandatory codes of conduct under the *Trade Practices Act (Cth) 1974*.

Dividends – Section 282(1)(c)

Rule Options

What I have said in relation to rebates on the question of whether, under the Rules of the Co-operatives, the power to declare a rebate should rest solely with the Board or partly with the Board and partly with members or with members only, generally applies to Rules in relation to the declaration of dividends. The Rules should be drafted to accommodate the wishes of the members in the first place.

A common formula contained in Rules is to give exclusive power to the Board to declare an interim dividend in the course of a financial year and a power to the members to declare a final dividend at a general meeting provided that the rate of the final dividend does not exceed the rate recommended by the Board. It follows that if the Board does not recommend a final dividend there is no power in the General Meeting to declare one.

Flexible Dividends

There are three (3) subsections to section 153, the first two (2) of which are designed to give the Co-operative flexibility in respect of the declaration of dividends.

Provided that the Rules of the Co-operative authorise it, a dividend can be declared in respect of shareholdings in excess of a specified number of shares at a rate that is higher than the rate of dividend payable in respect of shares that do not exceed that number. It must be remembered that the regulations prescribe that the rate of any dividend cannot currently exceed 20% of the value of the capital of the Co-operative unless the Registrar approves in any particular case (see Section 282(3).

In addition, where the Rules authorise it, there can be different rates of dividend on shares based on the volume of business done by shareholders with the Co-operative.

Directors risk an action for discrimination made by inactive members if they declare a dividend based on shares held, which dividend is made payable to active members only.

In respect of both of these provisions, it might at first blush be thought that they offend Co-operative Principles but on closer consideration you will see that they provide for those members who patronize the Co-operative more extensively than other members to receive a greater rate of return from the Co-operative than members who do not patronize the Co-operative to the same extent. This, I think, conforms to Co-operative Principles.

The third limb to section 153 is simply a requirement that any dividend, bonus or rebate to a member must first be applied to paying any subscription or calls on shares which may at the time the dividend, bonus or rebate becomes payable, be due by the member and unpaid. Note that in this third limb of Section 153, there is reference to a "bonus" being paid to a member whereas section 282 refers only to bonus shares. It seems to me to be more likely that bonus in section 153 must refer to a bonus share and does not authorise the payment of a cash bonus to members. The word "bonus" in Section 153 may be a typo for "bonus shares".

Bonus Shares issued out of a Surplus or Part Reserve – Section 282(1)(b)

My view is that the right of a Co-operative to issue a bonus share out of surpluses contained in Section 282(1)(b) on the basis of business done or the number of shares held by a member is quite distinct for the right to issue a bonus share out of a capital profit or revaluation of an asset pursuant to Section 156 so that compliance with Section 156 is not required when issuing a bonus share pursuant to Section 282(1)(b).

Compulsory proposal to take up additional shares – Section 155

Section 155 enables all members to be required to take up or subscribe for additional shares in accordance with a proposal approved by a special resolution of the Co-operative. Some agricultural Co-operatives which need large amounts of capital for plant and equipment may wish to encourage members to continually subscribe for shares in the Co-operative by deducting an amount due to the members for produce supplied by the member to the Co-operative, for example, one cent a litre in respect of the supply of milk or half a cent a kilogram in respect of the supply of fish. The possibilities are endless. Often, the members whilst appreciating the fact that their shareholding in the Co-operative is growing would prefer to keep the one cent a litre to grow their own business rather than the business of the Co-operative.

Where this environment exists, the Co-operative can declare a cash dividend or cash rebate in favour of the members and then capture that cash dividend or rebate or part thereof by way of a compulsory share acquisition programme pursuant to Section 155. Of course, the members generally also look for a cash dividend that is not captured that they can keep which pays the tax on both the dividend that was captured by the Co-operative by way of the share acquisition programme as well as the cash dividend itself. This cash dividend could be based on business done and could to some extent compensate the active member for the compulsory deduction from their sales payment.

Reinvestment of Dividends and Rebates back into the Co-operative – Section 282(2)

Section 282 subsection 2 provides that any rebate or dividend payable to a member, may **with the consent of a member**, be applied in relation to the payment for the issue to the member of bonus shares or as a loan to the Co-operative.

This does not mean that every member has the right to convert their rebate or dividend into a bonus share or loan to the Co-operative but it does permit a Co-operative that is in need of funds to introduce, in effect, a voluntary dividend and/or rebate reinvestment plan under which members can, if they wish, reinvest their dividend or rebate in a bonus share or in a loan to the Co-operative.

Now that Co-operatives can have more than one class of share, a bonus share issued pursuant to Section 282(2) could be of a different class to the other issued shares and might for example have a fixed rate of dividend or rank in priority on a winding up to the other class of shares.

Should a Co-operative wish to attract loan funds for its members by inviting them to reinvest their dividends or rebates by way of a loan, in my view, it is not necessary for the terms of that loan to comply with Section 268 of the Act.

Section 268 enables a Co-operative to adopt a compulsory loan scheme. Broadly speaking, this requires a special resolution of members as does a compulsory share acquisition programme pursuant to Section 155 of the Act. Under Section 268 the term of the loan cannot exceed seven years.

Distributions to Non Members – Section 282(3)

One further provision of Division 4 of Part 10, which we have not discussed, which again requires an authorisation Rule enables a Co-operative to apply part of the surplus arising from the business of a trading Co-operative to be paid to a person who is not a member but is qualified to be a member by way of a rebate in proportion to business done with Co-operative if:

(a) the person was a member at the time the business was done and the membership has lapsed; or

(b) the person has applied for membership after the business was done.

This provision, in effect, enables participation in distributions for applicants for membership who have not built up a shareholding out of deductions from their receipts for goods supplied to a sufficient extent to be qualified for membership or alternatively for exiting members who did business with the Co-operative in the period for which the rebate is being paid but have since ceased membership.

Payment in Kind for Co-operative Shares – Section 154

Finally, I wish to draw attention to Section 154 which enables a Co-operative, again only if authorised by its Rules, to issue fully paid up shares to an active member of the Co-operative where the consideration is not paid in cash but in kind, that is by way of real or personal property of at least the value of the equivalent cash consideration.

The Rules of a Co-operative should authorise the issue of shares to members in exchange for property pursuant to Section 154 as it could be called upon. One never knows.

Obviously, an active member may have an asset it is prepared to sell to the Co-operative which the Co-operative wishes to acquire. For example, some years ago a Co-operative acquired a crusher for extracting oil from olives and paid for the crusher partly in cash and partly in shares based on a valuation.

Another experience I had where the authorising Rule was applied was where two Co-operatives merged. This was effected by the smaller Co-operative A transferring its engagements to the larger Co-operative B. In this case, it was appropriate for the members of the smaller Co-operative A to receive an allotment of shares in the larger Co-operative B in exchange for a long term supply contract with the larger Co-operative B. The long term supply contract was regarded by the law as an item of personal property upon which a valuer opined a value.

Summary

1 Capital Gains not generally available in respect of shares – could be made available in respect of CCUs.

2 Bonus shares can be paid out of a capital profit on the sale of an asset or as a result of a revaluation of an existing asset.

3 A distribution out of a reserve to members could have the unintended consequence of being payable to former members.

4 No obligation to distribute any part of a surplus.

5 Surpluses can be distributed by way of bonus shares, dividends or rebates based on business done.

6 Dividends can be at a higher rate over the base rate for shares held by a member exceeding a specified number of shares.

7 A compulsory share acquisition program can be used to capture dividends subscribed for shares and can be ameliorated by cash dividends.

8 Voluntary reinvestment of dividends and rebates back into the Co-operative can be made available to members at their election.

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