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Law Commission Consultation on Co-operatives and Community Benefit Societies

Response by Bates Wells

10 December 2024

1. Introduction

At Bates Wells we are often asked by social and community-based entrepreneurs of different kinds for advice on choice of legal form and on related constitutional, governance and structuring questions.

This often means appraising co-operatives and community benefit society legal forms alongside other potential legal form options.

The legal framework for societies has needed attention for some time, and we welcome the Law Commission's review of that framework and the very useful content of its consultation paper published in September 2024.

It is important that any reform to the law is undertaken in the context of the broader landscape of 'social enterprise' legal forms and options, and which facilitates innovation and organic development in the use and activities of these forms. The legal framework should provide certainty for those who wish to use the distinctive characteristics of societies to operate their businesses.

Our response to the consultation paper questions is informed by our experience advising in this area for many years, as well as through conversations with many in the sector. We have also been part of two legal groups collectively responding to the consultation – the Charity Law Association Working Group, and the 'CCBSA Lawyers' Group'. We cross-refer to the responses prepared by both those groups in our answers below.

2. Distinctiveness of Co-operatives and Community Benefit Societies

One of the animating questions in the consultation seems to be "what makes co-operatives and community benefit societies distinct from companies or other legal forms of business association".

This is a good and valid question. However, if it is pushed too far, it might limit the use of co-operatives and community benefit societies to those few situations where these are the only appropriate legal forms. In practice, we anticipate that there will be various situations where the business could be structured as a co-operative or a community benefit society, or as a company, or in another way. We think that it is therefore worth thinking of the definition and criteria for registration as allowing for a degree of overlap in suitable cases and we do not think that it should be fatal to an element of the definition that *some companies* may be similar.

In our experience, the co-operative and community benefit society legal forms are generally appropriate and desirable for our clients, as against other legal form options, where the venture is by its nature democratic, and is not driven by the capital requirements of a small group (as many start up companies tend to be). For co-operatives, the venture may predominately be for member benefit. For community benefit societies, predominantly for community benefit.

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The co-operative and community benefit society exemptions from the financial promotions rules make these forms particularly attractive as *vehicles for raising capital from groups of smaller shareholders with an inherent connection to the venture beyond the purely financial, which may include communities for community enterprises*. These exemptions are distinct and material advantages for these forms as against other legal forms. We think that the preservation of this advantage should be a high priority with respect to any law reform process.

What is important is that the essence of the form is defined with greater certainty in legislation, and that the definition allows greater certainty at the point of registration and in dealings with a regulator or registrar throughout the life of the enterprise. We expect that, at the margins, there will and should be an ongoing need for discretion at registration.

We recognise the scale of the challenge involved in this review and that some of the proposals the Commission receive (including in this response) will not be ready to be dropped into legislation. Rather, they will need further refinement and discussion amongst the sector. We would welcome further opportunities to feed into those discussions after this phase of the consultation process has finished.

3. Definitions

We are in favour of an improved statutory definitions for the reasons noted in the consultation paper. However, we would take a different approach to that suggested in the paper.

We support the views of the CCBSA Lawyers' Group in this respect. In particular, the proposal for a definition of a society based on purpose – see section 1 of the CCBSA Lawyers' Group paper. We also agree with the comments made by the CLA Working Group on this issue – see the "Introduction and general comments" section of their response.

We are particularly concerned with the proposal that any new definition should have retrospective effect, as this would place the registration of existing co-operatives at risk, even if only for technical infringements. Many of these societies have made plans and built business structures and relationships based on the law as it was at that time, which would be impossible to unwind without huge disruption.

If the definitions approach suggested by the CCBSA Lawyer's Group is followed, then there would be no need to threaten de-registration for failure to fall neatly into one of two definitions (of co-operative or community benefit society). Adopting this approach therefore has the added benefit of being able to deal with transitional issues, and also to account for the "pre-commencement societies (i.e. those registered before 1 August 2014)" who were not required to register as either co-operative or community benefit societies. We share the CLA Working Group's strong objections to the idea of retrospective conditions for registration being placed on existing societies.

4. Elements of a society

Democratic structure

We agree with the CCBSA Lawyers' Group and CLA Working Group that a key feature of the society structure is that it is a democratic, member-led organisation. We agree with the detail provided on this point in section 1(a) of the CCBSA Lawyers' Group response, and section 3 and 6 of the CLA Working Group response.

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In particular, whilst one vote per member should be the starting point, in our view consideration should be given to the possibility of derogations or exceptions to the requirement for one vote per member. For example, we consider that there will be occasions where a charity might wish to provide capital or other resources to a co-operative and to retain certain controls or blocking rights on key issues but where the enterprise is otherwise democratic. A strict one member, one vote requirement would unnecessarily limit structuring solutions which might be perfectly appropriate and suitable where, for example, charities are looking to form or support societies.

Transactions with members

We think it would be a mistake to require in any statutory definition the condition that benefit to members is provided "through transactions with its members". This would appear, for example, to prevent co-operatives which provide renewable energy directly into the electricity grid from continuing to meet the definition, through no fault of their own. It is a feature of the electricity grid that power cannot be provided directly to members of the co-operative and so it is not within the power of these co-operatives to benefit their members through transactions with members; it would be arbitrary to deregister them as a result.

To say that such co-operatives are not "bona fide" seems unnecessarily purist and idealist. Whilst the transaction is not with the member itself, where the society still operates for the benefit of its members (for example through the negotiation of specific discounts for its members with the relevant supplier, or other incentives offered only to members), has a democratic structure, and is formed by members seeking to fulfil a common need (for renewable power), we do not see why the one 'missing element' of direct transactions should prevent its registration as a co-op. By contrast, some societies may be set up with the purpose of the creation of renewable power, regardless of how and whether members themselves take up that power themselves. We agree those societies do not seem to fit within the definition of member benefit, but community benefit, and therefore should not be considered a co-op.

We note the comments in section 3.74 of the consultation paper about when a "green co-op" might properly fall within the definition of a co-op (as proposed by the paper). We disagree that a members' benefit will need to be directly linked to a members' use of the tariff offered by the partner supplier. There should be flexibility as to how co-ops might choose to benefit members, including by way of discounts not linked to consumption (which would have the positive effect of not incentivising over consumption of energy, often a key aim of renewable energy co-operatives). It is true that companies may also operate in this way, but as above this should be a barrier to allowing co-operative societies to do so as well. In particular, because there would be other distinguishing features of the society form, such as the presumption of democratic control.

5. Community Benefit Societies

As above, we are in favour of a definition of society which can encompass community benefit societies, and so do not support a separate definition.

Commenting on the elements of a community benefit society raised in the consultation:

- a society carried on for the "sole benefit of the community" is seemingly inconsistent with any benefit to members, many of whom may also be members of the community and who may vary significantly in number and in status. We suggest that the concept of "sole benefit" should give way in favour of a balanced conception of community benefit.

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- We think it would be far preferable to have a definition of community benefit which tracks other more developed areas of the law, such as the law in relation to community interest companies and the law in relation to public benefit for charities. We think that this kind of approach, which requires "private benefit" to be no more than "incidental" would have much to commend it and would allow for more flexible and organic development of the law in line with adjacent areas. The law in relation to private benefit has proved itself to be relatively adaptable for different circumstances.
- Given the problematic nature of "sole benefit", we are even more concerned with the proposal that the new definition of community benefit society should have retrospective effect, as we suspect that, understood in plain English, it would place the registration of many community benefit societies at risk.
- The definition also has the same problematic concepts of membership being "open" and of "one vote per member" being an essential characteristic of the definition, as with the co-operative definition. For the reasons above, we think there should be some flexibility as to how this is interpreted. Indeed we would be in favour of the community benefit form being more open to a wider range of governance structures and arrangements in terms of voting and classes, so that it is better able to accommodate the different interests of different stakeholders, such as other community minded groups. We do not see why one member one vote need be as central an element of the definition as with a co-operative. It would seem disproportionate to prevent organisations from registering merely for breaching this principle, where such organisations are, for example, majority controlled by charities at general meeting.

6. Exempt Charities

We are sympathetic to the view that charitable community benefit societies should be registered with and subject to regulation by the Charity Commission. However, we anticipate that this could create unintended consequences, such as introducing a new requirement for charitable community benefit societies which are registered social landlords to comply with charity land requirement and formalities. It might therefore be desirable to create some new exceptions to certain forms of charity regulation.

We support the views given by the CLA Working Group on this issue (in relation to consultation questions 9 and 10).

7. Society Shares

We agree with the comments made by the CCBSA Lawyers' Group at section 4 of their paper in relation to share capital, interest on shares and dividends. We also support the views given in the CLA Working Group's response, in relation to consultation questions 11-27.

In addition, in our view:

- Any clarification to the law should include that shares can be both withdrawable *and* transferable. It was not clear to us from the consultation paper whether this was one of the permitted options.
- The test for an appropriate rate of interest on shares should simply be 'no more than is necessary to obtain and retain capital'. There is no need for another limb of the test (ie that the rate should also be 'reasonable') and it could cause confusion or uncertainty for societies when planning new projects and trying to raise capital. Further, deciding on what is 'no more than is

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necessary' should be a judgment for the directors, acting in accordance with their duties, rather than one that should or could be made by the regulator (potentially acting retrospectively). Only if a decision on rates is outside of the range of reasonable decisions that could be made in the circumstances should there be regulatory intervention.

- In our view, the proposed requirement that a society should pay for withdrawable shares "only if the officers of the society think that the society can also pay its debts at that time and as they fall due over the following year" is necessary but not sufficient, as it may be obvious to the officers that the society will go insolvent after 12 months or that allowing withdrawal now would be unfair to other members, if it is clear that it is likely to reduce the ability of other members to recover their capital over time. We suggest that a broader test, potentially drawing on some of the capital adequacy principles in company law, ought to be adopted which does not allow for irresponsible withdrawals to be implemented.
- With respect to the proposed definition of transferable shares, we suggest that there should be some requirement or expectation that consent to transfer will be given or will not be unreasonably withheld, in line with company law. As drafted, it is not clear that such shares would be transferable in an ordinary sense, if any transfer is always subject to the consent of the management committee of the society.
- It would be helpful to understand when and how, in the view of the Law Commission, transferable shares might be subject to regulation under FSMA and on what authority this interpretation rests.
- It would also be helpful to have confirmation that where shares are defined as being transferable only on death or bankruptcy, these shares are not deemed to be 'transferable' for the purposes of FSMA. Clearly if this were the case, many society share offers for withdrawable but non-transferable shares would fall within FSMA, which does not seem to be the intention of the legislation.
- The consultation references class rights but it does not say how these class rights relate to the principle of one member one vote e.g. would it be permissible to have differential voting rights between classes? In our view, there may be situations where it would be desirable to have different share classes and differential voting rights between classes, provided such structures are consistent with the democratic nature of co-operatives and the community benefit nature of community benefit societies.
- The consultation paper states "*There is a concern in the co-operative sector about profit-seeking whereby profits from a co-operative are extracted from the co-operative enterprise for the private gain of investors. The risk is that the focus of the business might become returns for investors rather than transactions with members.*". It is not clear if this concern is well founded or if there is evidence for it. In our experience, the democratic nature of a co-operative is usually a major deterrent to 'pure' investors, who are used to structures which operate on a weighted voting basis where votes reflect capital invested. In our view, this risk – if it is a real risk at all – should be managed through the duties of the directors and by operating a disqualification regime where directors commit egregious breaches of their duties.

8. Duties of officers

We endorse the suggestions made in section 2 of the CCBSA Lawyers' group in relation to codifying the legal duties of society officers. The duty of officers is to deliver the purpose, and it is primarily for the members to ensure that the officers discharge the duties. The formulation of the duties should be

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based on s172(2) Companies Act 2006, with suitable adaptations as set out in the CCBSA Lawyers' group paper (where references to 'company' should be to 'society').

We also support the proposition that legislation should grant members the power to remove an officer, similar to section 168 of the Companies Act 2006.

9. **Audit requirements**

Although we are not accounting experts, we have been made aware of the difficulties caused by the current audit rules for particular societies, and welcome the Commission's attention to this issue. Below is an explanation we have received on the current issue, and a request to the Commission:

Section 84(1) of the 2014 Act contains a provision to disapply the requirement for audit in Section 83. However, Section 84(1) does not apply if the society has a subsidiary (sub-section(3)(c)). This prohibition is causing a specific issue for community sports clubs which are registered societies. Many such societies can and have registered with HMRC under a favoured tax arrangement known as the Community Amateur Sports Club (CASC) scheme. The CASC scheme conditions require a club's non-sporting income e.g. from the club bar not to exceed certain financial thresholds. Registered society CASC's which are successful in generating "commercial" non-sporting income from non-members in order to survive have had to set up a trading subsidiary to carry out these commercial operations. As a result they fall foul of the subsidiary prohibition and are required to have an audit which can cost £10,000 per annum or more. This reduces the valuable savings from being a CASC (successive Governments have supported this scheme). Paragraph 7.199 (2) of the consultation paper seems to indicate that the current list of societies which cannot opt out will be kept, but this caveat does not appear In Question 67. The registered societies which are CASCs would not be required to have an audit if they were constituted as companies under the Companies Acts. We would strongly recommend that this trading prohibition be removed for societies with subsidiaries where they are within the regime proposed in Paragraph 7.201.

10. **Duties of the Registrar**

We endorse the points made in section 6 of the CCBSA Lawyers' Group paper, and by the CLA Working Group in answer to question 39.

11. **Asset lock**

We endorse the points made in section 5 of the CCBSA Lawyers' Group paper in respect of asset locks, and that a society with a community purpose should be able to convert to a charity, despite the asset lock.

12. **Restoration of societies to the register**

We agree with paragraph 66 of the CLA Working Group response, and support a process for restoration of societies to the register who have been cancelled.

13. **Policy**

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Recognising that this is outside of the scope of the consultation, we endorse the comments at 8.3 – 8.10 of the consultation paper, and in particular the statement at section 8.10.

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