Reflection

on

The Nature of a Co-operative

Introduction

The Law Commission has been asked to consider, amongst other things, whether the statute law which governs co-operatives is fitting to their nature. But what is their nature?

One of the questions most frequently asked about co-ops is how are they different, which is really a question about their nature, meaning how are they different from a company. A company is what people know about and is assumed to be the norm against which any differences need to be explained.[1] As will become apparent, this is an unhelpful starting point, because properly answering the question about the nature of co-ops requires deconstructing the assumption that a company is some sort of norm or natural starting point.

There is a further problem with this approach. Comparison with a company tends to be seen as a question about structure, leading to identification of structural differences. This is also unhelpful; although the structural differences are significant and need to be considered, the more importance difference in nature relates not so much to structure as to *how co-operative business is conducted*.

That difference is something not generally understood in the UK, for reasons that will be explained. But it needs to be understood in order to make sense of the structural differences. More importantly, it needs to be understood to explain the nature of a co-operative, how that nature is different from a company, and why co-operatives are important in the context of the climate emergency. That is the purpose of this reflection.

1. Co-operative trading

Origins

It is generally accepted that the Co-op Movement started when a group of pioneers opened their shop in Rochdale in 1844. The radical innovation involved in this wasn't so much a clever new legal structure; it was the completely different way of doing business.

In Victorian England during the industrial revolution, many people were living in extreme poverty and insanitary housing. With no public transport and little real competition, customers were dependent on the small number of shops they could walk to. Much food on sale was contaminated and frequently overpriced, and cheating on measures was rife. The normal market mechanism was failing or broken, and ill-health and premature death were common. This was the context for the idea of collaboration between people within communities in order to meet a shared need.

[1] A company can take a variety of different forms as discussed below, but the most common form which is generally treated as a norm is a company limited by shares which are owned by investors.

Twenty-eight individuals contributed initial funding to enable one of them to walk to Manchester to buy goods wholesale on behalf of everyone else. The goods were then brought back to premises in Rochdale from which they were sold, at a price to cover costs, to those twenty-eight people and other members. Why was this so radical?

- This approach did away with the traditional shop-customer relationships; there were no longer two parties with competing interests – a seller and a buyer – because the customers or members *were* the shop. They (or their representative) bought the goods in the market on everyone's behalf, which were then sold back to members individually.
- Because the customers *were* the shop, they were in control of what goods were bought, how they were stored, packaged and presented for sale. Contamination could therefore be eliminated. They could ensure that the scales were accurate, and no cheating occurred at the counter.
- The goods, of course, had to be paid for by the customers, and they needed to make sure that customers only paid a fair price, without a profit margin inflating the selling price. The cost price of the goods was known, and so customers could be charged the appropriate amount plus an additional sum to cover transport and other overhead costs. But the price paid was only a provisional one, because the true cost could only be established when the accounts for the shop were prepared at the end of the quarter.
- At this point, after appropriate provision was made for reserves and other contingencies, it was possible to discover the actual or fair price. If there was a substantial surplus, customers had paid too much. Every transaction for every customer was recorded in a ledger, enabling a rebate to be calculated and paid to each member in relation to every such transaction. This was the co-op dividend: an ex post facto price adjustment or rebate to achieve a fair price.
- Non-members were also allowed to shop in the co-op store, but depending on the rules of the society, they may not be entitled to a full rebate or any rebate at all. This was to encourage membership.
- Substantial surpluses were generated from trade. Although the dividend/rebate put significant funds back into the hands (or accounts) of members, before the amount of dividend was decided by members, other "distributions" were made first, including to reserves, an education fund, funds for cultural and social events, supporting members in distress, community projects such as schools or hospitals and other local needs. Surpluses benefitted the wider community.

This certainly was a radical approach, very different to what generally applied at the time, and still is today.

Contract law

When we buy things today, it involves a shop or seller, and a customer. Shopping involves two parties completing a legal transaction or contract under which one pays for something supplied by the other. The contract contains the terms, including what happens if the goods aren't up to scratch, or the customer doesn't pay. Contracts may be express (often in writing) or implied and may or may not be supplemented by legislation protecting consumers in particular circumstances.

The origins of contract law can be traced back to ancient times, but modern contract law was substantially developed by the judges (so-called 'common law') in response to the industrial revolution. The capital requirements for building factories, canals and railways required a mechanism which provided businesses with a degree of certainty. When seeking funds from investors, they needed to know that future supplies could be secured, workers were committed to the business, and that customers would pay for their goods.

As it evolved in the law courts, contract law was developed to provide this certainty. By establishing the specific criteria that had to be met for a contract to be legally recognised as valid (offer, acceptance, consideration, intention to be bound), the law courts were able to specify where they had jurisdiction, and where their authority could be called upon by businesses or individuals to interpret and enforce validly made contracts.

The development of the joint stock company is sometimes referred to as one of the most influential inventions of the Victorian age, but it was contract law, enshrining the principle of the *binding force of contract*, which provided the certainty for trading which companies needed. Enforceability was fundamental to this, alongside the other essential principle of contract law, *freedom of contract*: the ability for parties to make binding agreements of their own choice. These principles were the foundation of a competitive economy and became the basis of free-market thinking, enabling individuals and companies to have the freedom to meet every kind of human need without requiring state interference, but with the ability to call on the authority of the law courts for enforcement, if needed.

Limitations of contract law

Whilst contracts facilitated the building of a 19th century industrial economy and all that has followed, they did not work for everyone. It was the law courts' job to enable the enforcement of contracts, but it was not their job to look behind validly made contracts, even if they looked one-sided. In practice, contracts are often made where the bargaining position of the parties is unequal; but the freedom of contract principle established from the outset that the fairness or otherwise of a contract to the parties involved was a matter for the parties themselves, not the court.

Contract law has been an essential feature of trade and industry for more than two centuries now, but over the years, it has been felt necessary to deal with particularly obvious forms of exploitation. Judges and the concept of equity developed principles to address particular types of blatant abuse, but Parliament still needed to intervene to introduce legislation to protect the interests of buyers[2], workers[3], or consumers of particular services[4], or (more recently) the environment[5]. This has enabled particular imbalances of bargaining position to be addressed by imposing minimum standards which society expects, whilst leaving contract law in place as the essential mechanism for trade.

Such targeted legislative intervention is a substantial part of the overall legal infrastructure for trade today[6]; but it is generally catching up after the event, and it doesn't provide a

[2] Sale of Goods Act 1893
[3] Factories Act 1847, Employment Protection Act 1975
[4] For example, Financial Services and Markets Act 2000
[5] Environmental Protection Act 1990
[6] All part of what is generally called "commercial law"

solution in every situation. Unfairness, hardship and exploitation are a constant factor in a contract-based, free-market competitive economy. Such was the case in Rochdale in 1844 where the market was failing to provide people with access to what they needed. This was the context in which co-operation was established as an alternative mechanism to contracting.

Co-operation instead of contracts

The radical step taken by the Rochdale Pioneers was to eliminate the idea of a binary contract between two parties with competing interests (a buyer and a seller). Instead, there was a collaborative arrangement between those sharing the same need, and by working together collectively they could all meet that need through co-operative arrangements expressly designed to be fair to all. These arrangements included the following:

- nobody was to enjoy any special reward or benefit;
- everybody was to be treated equally in the business with an equal say;
- the arrangements were open to anybody who needed to avail themselves of them;
- everybody (over time) had to contribute a minimum to the funding of the enterprise;
- any surpluses generated from the trade were to be applied to build reserves, and subject to that to be returned to members in proportion to their historic purchases as a price adjustment (dividend).

These guiding principles became known as the Rochdale Principles.[7] The formal arrangements setting out the collaborative relationship between the members were contained in the rules or constitution. This was the legal document which governed the members' relationship with each other, and how trade was to be carried out. When a member bought something in the co-op store, it was a transaction within the co-operative and under its rules: there was no market-based contract.

The idea of transactions under co-operative rules instead of contracts is not generally known about or practised in the UK today. It is part of the mutual heritage which has been lost here. The traditional "co-operative dividend" has been phased out in the retail sector, and generally co-ops use traditional contracts in most or all areas of their operation just like other businesses. There may be some circumstances where co-op rules rather than a contract still apply; where primary co-ops establish a jointly-owned and controlled secondary co-op, and that secondary co-op provides goods and services to the primary members under the rules. Even here it may be more common today to clarify the arrangements through contracts. Contract law undoubtedly prevails in the UK.

What are the implications of this?

Where the relationship between parties is contained in a contract, the ultimate remedy is for one party to take the other to court and seek enforcement. This might result in a judgement which cannot be met, potentially leading to the insolvency and liquidation or bankruptcy of the defaulting party. Such an outcome may be harsh, but it is the legitimate consequence of entering into a contract: it is how the competitive market works.

[7] Now enshrined in the internationally recognised ICA's Statement of Co-operative Values and Principles

Co-operation is effectively an opting out of the market. Rules still apply but based on fairness rather than market advantage. Where the parties are bound together by the rules of a co-operative, the rules will generally contain a mechanism for dealing with disputes or with a member in default. This might include setting off any liability against the member's capital, loss of entitlement to dividend, or expulsion from membership if the members so decide. The member concerned may choose to leave instead. But it would make no sense according to the underlying values and principles to punish a member experiencing hardship, or to enforce a judgement with bankruptcy.

In summary, the difference between a contract and co-operative arrangements is as follows.

- A contract sets out the *rights of the parties as against each other*. It is essentially an adversarial relationship, concerned with the rights and interests of the parties themselves (so-called 'privity of contract' being another of the basic principles of contract law) and protecting each of them against the other in relation to any failure to perform the contract. Each is entitled and would normally be expected to enforce their contractual rights against the other – which is the purpose of the contract in the first place: to protect the private interests of the parties via a court of law if necessary.
- By comparison, a co-operative (in the words of the ICA statement) 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". In other words, the focus is on the voluntary nature, shared needs and the ability to meet them by collaborating. There is no compulsion. Members are at liberty to join or leave as they prefer. Mutual support and solidarity and alleviating hardship are the essence of the relationship. Members are expected to play their part, and historically it was not uncommon for societies to fine members in order to encourage compliance. But cooperation is not about private rights, or getting ahead of others; it is about shared need and achieving a shared goal of meeting everybody's needs.

Other jurisdictions

In other jurisdictions today, particularly Hispanic and Italian, cooperation as an alternative basis for commercial relationships is well established and understood. In these countries, a member buying goods in their co-op is engaging in a "co-operative act" under the rules of the co-op; there is no consumer contract. By contrast, where a non-member buys goods in a co-op shop, it cannot be a transaction under the rules because the customer is not a party to the rules. It is therefore a market transaction, just like any other non-co-operative business.

In these jurisdictions, co-op businesses must keep two sets of accounts: one for trade with members, and one for non-member trade; because the nature of those transactions is different. How the surpluses from these two types of trade are treated may differ, as may the accounting treatment and tax treatment. But it is the trade with members that comprises the co-operative economy – namely that part of the business comprising transactions carried out under principles of fairness and solidarity, rather than under market principles of competition for private benefit.

Although this concept is little known about in the UK today, no legislation is needed to make it possible: just the willingness of the participants to operate in that co-operative way. There

is also now one clear example in the UK where this traditional co-operative approach is already being followed.[8]

Ethics and values

There is a growing appetite today for an ethical or values-based approach in business.[9] This reflects a recognition that an unmitigated market-based approach may be the traditional way of conducting business, but its focus on private benefit and return on capital runs against the need to recognise the external impacts of business. In particular, in the context of the climate crisis and Sustainable Development Goals, there is a need to reassess how business operates, and to build into that modus operandi concern for workers, customers, neighbours and future generations.

At the heart of this is the concept of fairness. It is possible to rewrite contracts to introduce a focus on externalities and fairness and those devoted to that work deserve full support[10]; but that is not the purpose for which contract law was developed and now exists. An alternative and more challenging approach is to change the very basis of commercial relationships themselves, from competition to co-operation.

2. Co-operative nature

It is clear from the above that there are more than just structural differences between a company and a co-op. Although they are both artificial legal persons, with limited liability and perpetual succession, they each exist to facilitate a different way of doing business. As a result, co-operatives and companies have different legal purposes.

Purpose

For its first 162 years, company legislation was silent about the purpose of a company. This did not mean that it was unclear; on the contrary, it had been developed over that period by many decisions of the law courts, but never put into statute. That changed with the Companies Act 2006 which for the first time codified the duties of company directors in statute. This required the legislation to specify the purpose for which a company exists, because the duties of directors specifically relate to delivering that corporate purpose.

Section 172(1) of the 2006 Act requires a director to act "… in the way … most likely to promote the success of the company for the benefit of the members as a whole …". The subsection goes on to mention other matters that a director must "have regard … to …" but that does not detract from the basic duty just articulated, namely the benefit of the members. That wording for the first time enshrines shareholder primacy in statute as the default purpose setting for companies.

Section 172(2) makes it clear that this default setting can be changed. It states:

---

[8] CNI and the provision of a fibre network for internet connectivity in a geographical region

[9] See, for example, Anthony Collins Ethical Business Project

[10] The work of The Chancery Lane Project is committed to "using the power of climate contracting to deliver fast and fair decarbonisation".

> *"Where or to the extent that the purposes of the company consist of … purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes."*

This provision confirms that the "benefit of the members" in the previous subsection is the "purpose(s)" of a company. This is also now the legislative confirmation of the principle that unless stated to the contrary in its articles, the purpose of a company is private benefit.

This is important because in seeking to understand how a co-op and a company are different, we now have a clear statutory statement of a company's purpose: private benefit. It can immediately be seen that this contrasts with the purpose of a co-op. Although the purpose of a co-op has not so far been articulated in this note, it will already by clear that it is not for anybody's private benefit. Indeed the opposite: it aims to treat everybody fairly and not to prefer any private interest.[11]

The purpose of a co-op is to provide access to goods and services to those who would otherwise be denied such access on a fair basis. Clearly goods and services are provided for the benefit of members, but it is not for their *private* benefit. The principle of open membership means that such opportunity is open to anybody. And the limitation of a member's rights to a return of their capital with no entitlement to a share in the underlying value of the business similarly precludes any "private benefit". The UK movement has not settled on a definition which accurately describes the purpose of a co-operative, but the phrase "for the common good" is considered by some to be appropriate description, and in contrast to "for private benefit".

It should also be noted in passing that as explained above, company law enables companies to adopt a different purpose, and charitable companies limited by guarantee are an example of this. In that sense, in theory a company provides a blank canvas, enabling members to articulate a different purpose. Without specially designed ownership and governance arrangements to protect and secure a different purpose, and some over-riding guiding principles like charity law, there is always a risk that it will revert back to the default approach.[12] Even community interest companies limited by shares face this challenge, with the low level of supervision or scrutiny of the community interest provided in the legislation.

Nature

Clarity about purpose is important because it enables the difference in nature to be identified and articulated. It becomes clear that company law focusses principally on the perspective of those setting up, owning and running a company: shareholders and directors. That priority is necessary, because attracting capital/investors is the critical factor.[13] Central to this is the idea of limited liability, and the so-called 'corporate veil', separating the interests of individual shareholders from that of the company itself. The company is something entirely and legally

---

[11] This is made clear in section 2(3) of the Co-operative and Community Benefit Societies Act 2014: "… 'co-operative society' does not include a society that carries on, or intends to carry on, business with the object of making profits mainly for the payment of interest, dividends or bonuses on money invested or deposited with, or lent to, the society or any other person."

[12] There is a constant challenge for co-operatives, often referred to as isomorphism, where they are treated as if they were companies and expected to operate and behave as such, in spite of the difference in nature.

[13] The Modern Company Law review which preceded the 2006 Companies Act made this abundantly clear

separate from its shareholders; their risk is confined to the share capital they contribute; they have no formal legal responsibility for the activities of the company. Their legitimate concern is with the profitability of the business and its underlying value. It is for those running the company to be concerned with how profitability is achieved.

By contrast, the members of a co-op *are* the co-op. The very purpose of them coming together is to act collectively and to identify with the co-op, to bring their trade to the co-op and to establish a long-term trading relationship. The objective is for the co-op to meet the needs of those whom it is serving and those whom it may serve in the future. Consequently the focus of co-operative law and arrangements are on those whose needs it seeks to meet: namely customers, workers, the wider community and future generations.

This important difference illustrates why co-operatives have such an important future role to play in the context of the climate emergency. Co-operation enshrines an approach to enterprise which is inherently focused on those who need goods, services and jobs – namely everybody. It seeks to do so fairly, without preferring or exploiting anybody, and considering the impact of the business, on workers, customers, suppliers, neighbours and future generations. This is clear from the moral components of the ICA Statement[14], as well as the ownership principles under which, unlike companies which distribute profits to shareholders in year, co-operatives retain surpluses to continue the business for future generations.

Company and contract law, by contrast enshrine, an approach to enterprise inherently focussed on the private benefit of those providing funds. It only looks to the needs of those outside those private interests, generally referred to by economists as “externalities”, where forced to do so by law or the need to manage reputational damage.

Concluding comments

The fundamental difference of nature between a company and a co-operative are that the former aims to facilitate enterprise for private benefit and the latter to facilitate enterprise for the common good. It is important to take this as the starting point when considering further matters of importance in law reform, such as capital, governance. But the important point to make in conclusion is that whilst company law now clarifies the purpose of a company in legislation, this is not yet the case for co-operatives.

It is difficult to see how modern legislation for co-operatives and community benefit societies can be fitting to their nature and needs without addressing this basic question of purpose, which is intricately tied up with the question of definition.

Cliff Mills

Consultant, Anthony Collins and Principal Associate, Mutuo

[14] Education, Concern for Community, social responsibility and caring for others