

# THE ACCOUNTANT

## CONVERTING AN LLC INTO A CO-OPERATIVE PART 2: BACKGROUND AND ANALYSIS

### THE CORPORATE GOVERNANCE ASPECT

#### *Once in a Blue Moon – The Two-tier System*

With the two-tier structure being optional under the Co-operative Societies Act (CSA), many co-operatives are disregarding such alternative and opting towards the one-tier system. Upon affecting mutualisation, limited liability companies (LLCs) need not necessarily change their corporate governance structure to that of a two-tier one with a specific supervisory board. As an alternative and as illustrated in Figure 1, co-operative entities, especially larger ones, may make up their statutory Committee of Management (COM) of non-executives, with the day-to-day decisions being left over to an executive management committee, formed by the higher level managers of the co-operative. In such a corporate governance structure, it is imperative that the appropriate liaison is maintained between the two committees. Furthermore, in larger co-operatives, an Audit Committee may operate as a sub-committee of the COM on the lines of those established by LLC's.



#### BLUE SKY THINKING: THE POSSIBILITY OF HAVING INDEPENDENT OUTSIDERS ON THE COM

Upon conversion, one may need to consider the position of certain individuals who, within the company structure, had the opportunity of offering their professional skills and abilities as outside independent directors. As they were never shareholders in the LLC and do not envisage becoming members of the co-operative, they would not be able to extend their corporate governance contribution to the co-operative. This is because, at present, the law allows only co-operative members to be elected on the COM. In view of this, management may find it more difficult to manage a co-operative successfully and at the same time retain the wide-ranging outlook common in an LLC as external experts are generally excluded from being co-opted on the COM, this often leading to substantial skill gaps in the direction of the co-operative.

### THE COLOUR OF MONEY: THE FINANCIAL ASPECT

#### *The Bleak side of Collective Ownership*

Co-operatives tend to find it difficult to generate the required finance in terms of equity capital and are generally formed with a very low amount of share capital. The raison d'etre for such a matter generally emanates from the collective ownership of co-operatives, wherein in such an entity there is little, if any, advantage in holding more equity, given that, members mostly receive returns in proportion to the business volume. On top of this, all co-operative members are bound by the one-member one-vote principle, irrespective of the amount of shares invested.

A further complicating financing factor is that whilst in small companies there may be owner-directors willing to provide collaterals and guarantees, in co-operatives, which are mostly small in size besides being owner-directed, difficulties may be encountered in view of their tendency to have a relatively large number of members, rendering it difficult to achieve unanimity about the provision of such personal guarantees. Conversely, such a problem may not be encountered in a large LLC, as such companies tend to have more of their own assets which in turn serve as collateral for any loans taken out.

Yet, other ways of overcoming this financing difficulty may be considered. For example, could not the possibility be explored of having more members offering loans to their co-operative or leaving their share of patronage refund at reasonably negotiated interest rates, once such members are sufficiently determined to have their entity grow and prosper? In turn, such members may be given further incentives, such as the ability to buy from the co-operative at reduced prices. Alternatively, the Central Co-operative Fund (CCF) may act as a guarantor to co-operatives, thus helping them to obtain the required funds. Of course, considerations such as capping the amount of the guarantees and the scrutiny of the financial position of individual co-operatives would still be necessary.

A further possible measure is to introduce an internal inter-member rule, if not a statutory provision in the next CSA update, whereby whenever the share capital of the co-operative is eroded by losses, members bind themselves to restore such capital proportionately, on an annual basis.

### THE VALUE OF CO-OPERATIVE SHARES

Valuation build-up in a co-operative seems to be looked at with suspicion, and not expected to grow in line with the capitalist principles of companies. Therefore the question remains: what value is to be attributed to such co-operative shares upon leaving the co-operative, say on retirement or on resignation? The greater the difference in valuation being attributed between an LLC and a similar co-operative, the less the incentive towards mutualisation. Perhaps the law should be clearer in this respect.

Of course, the counter-argument to this runs that the social aspect of co-operatives needs also to be kept in mind. Ultimately, co-operative members are not normally interested in the maximization of commercial value but more in enhancing the co-operative's quality of service and in continuing the fruitful engagement of all the stakeholders involved such co-operatives.

### BONUS SHARES, BONUS CERTIFICATES AND SCRIP DIVIDENDS

The CSA provides different ways for members to finance the co-operative, including bonus shares, bonus certificates and scrip dividends. Careful use of these sources of finance avoids the 'asset lock' referred to earlier on, while at the same time, mitigates cash flow problems for the specified period. In particular, more bonus shares and certificates than at present may be issued in compensation for the retention of any patronage refunds. Yet, for such schemes to succeed, a fair dividend policy must be ensured in subsequent years. Furthermore, allotting these instruments may result in two dilemmas: first whether or not to require such extra financing as further compensation from new members in addition to admission fees; and secondly, whether or not the need will arise in the future to perpetuate the financing provided by such instruments. As for the second issue, in order to cater for the possibility of future financing needs, co-operatives need to undertake careful financial planning.

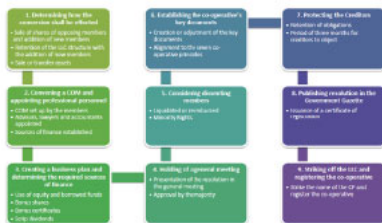
## A CHANGE IN CAPITAL STRUCTURE?

Given the above and in order to ensure that the concept of a co-operative is solidified, it is imperative to note that upon carrying out mutualisation, the entity needs to ensure that members do not have grossly different shareholdings, irrespective of the amount of shares each member originally holds in the LLC. Furthermore, patronage refunds will start to be distributed to the members according to their work contribution, thus ensuring that members working more than others are given extra compensation. Sustaining this view, any minority shareholders not wishing to effect such conversion may be bought out. Nonetheless, by law, shares are movable property by nature and thus, shareholders cannot be forced to sell such shares, in which case, there may be individuals who, though not genuinely interested in the entity, still remain shareholders.

## ROLLING OUT THE RED CARPET - THE REGULATORY PERSPECTIVE

From this research study, it became clear that one should ensure that LLCs should be in a position to adequately carry out structural changes by following a specific regulatory procedure in order to effect mutualisation, thus ensuring some form of continuation and more transparency in the procedures being carried out.

In view of this and in line with the CA, the CSA and extant foreign legislation in some other European countries, a regulatory procedure may be considered. In this context, for the mutualisation process to be orderly, it is recommended that nine stages may be introduced in the forthcoming CSA update as summarised in Figure 2:



## CONCLUDING REMARKS

In conclusion, change is important and the need to install new provisions in the law to facilitate the orderly conversion of such entities seems to be imperative. After all, the recommended changes are like having traffic lights installed in a main avenue: their installation enables the changing of colours, thus ensuring the orderly transition of traffic.

For detailed references, please refer to authors or, for most quoted sources, to the University of Malta MAccty dissertation "The Conversion of the LLC into a Co-operative and its Implications: A Maltese Analysis" May 2014 available at the University of Malta library.

### ABOUT PETER J BALDACCHINO AND JOANNE BORG



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Joanne Borg obtained a First Class degree in Bachelor of Commerce and graduated with a Master in Accountancy from the University of Malta in November 2014. She is an associate of the Malta Institute of Accountants. Joanne holds the position of a senior advisor in the Specialist Advisory Services Department at Nexia BT, with the main areas of specialisation being corporate finance, cost and management accounting, as well as business and succession planning. Prior to joining Nexia BT in 2014, Joanne enjoyed a work experience as a student intern in Advisory at KPMG Malta. In addition, Joanne has been awarded the Department of Accountancy award for the best dissertation in the subject area.