THE ACCOUNTANT

CONVERTING AN LLC INTO A CO-OPERATIVE

PART 1: BACKGROUND AND ANALYSIS

INTRODUCTION

In certain instances, businesses may decide to convert into co-operatives, subsequent to consideration that such an alternative legal structure may be a more viable path to their entity. Nonetheless, such conversions have as yet been a rare occurrence in Malta, rendering them less prevalent and ubiquitous. This emanates from a lack of awareness and understanding, as, in theory, this route can be taken up by any business which puts its efforts towards such a conversion, although various technical elements would need to be addressed throughout the process.

The objectives of this article, which builds on a 2014 MAccty dissertation, are to provide useful insights on the rationale for and the difficulties encountered in carrying out such conversions, to evaluate the corporate governance and the financial implications of such a change, and to propose a viable regulatory framework for implementing such conversions. The methodology for this research consisted of semi-structured interviews with nine accountants and four lawyers, all proficient in the co-operatives' field, as well as eight co-operative experts competent in the accountancy field. The statistical program Minitab Version 17 was used to calculate the mean, standard deviation, lower bound and upper bound using a 95% confidence interval for the mean, for each question and for each group combination, while the one-way Anova test was used to calculate the p-value.

Converting an existing company into a co-operative raises the question of what a co-operative actually is. A co-operative is defined by the International Co-operative Alliance as an "autonomous association of persons [being its members] united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise". This is distinct from a Commercial Partnership (CP) which is defined as "a contract whereby two or more persons place a thing in common with a view of sharing the benefit which may be derived from the exercise of one or more acts of trade" Cremona (1984). Unlike limited liability companies (LLCs), co-operatives are directed by seven principles: voluntary and open membership; democratic member control; member economic participation; autonomy and independence; education, training and information; co-operation among co-operatives and concern for the community.

WHY MUTUALISATION?

The process whereby a shareholder-owned company is converted into a co-operative (also called mutual organization) is termed mutualisation. As stated by Chris Banks, Chair of the Public Chairs' Forum in the UK, the challenges which companies face may instigate them to review the various aspects of their business and come up with a different ownership structure. Nevertheless, if such a need does arise, such companies would ultimately discover that to date, there is no easy and clear regulatory procedure to affect such conversions.

Mutualisations may empower and instigate staff to work in a more efficient and effective way, whilst encouraging them to focus even more on the success of the organisation in order to share in its success (Banks, 2011). Additionally, direct ownership in an entity gives the members a greater sense of personal ownership and a more meaningful voice in the governance of the organisation. In turn, the feeling of ownership may lead to a greater sense of commitment towards the entity, leading to greater productivity, effort and innovation (Michie and Maura, 1999).

This is in turn beneficial as numerous studies indicate a direct and positive correlation between high levels of employee participation and increased performance and production. Research repeatedly shows that firms with employee ownership and active staff involvement can outperform more conventional forms of business with outside shareholders, and be better places to work in (Field Fisher Waterhouse, 2011).

THE REGULATORY AND FINANCIAL ASPECTS

The Code of Principles of Good Corporate Governance falls short of focusing on the corporate governance needed in co-operatives, as such entities need more supervision due to the application of democracy. Nonetheless, the Companies Act (CA) and the Co-operative Societies Act (CSA) lay down a number of mandatory positions which are essential in promoting good corporate governance, these mainly being the Board of Directors (BOD) and shareholders in a company, and the Committee of Management (COM) and members in a co-operative.

In pursuance of the German model presented by Hans Munkner in the seventies, the original CSA (1978) required Maltese co-operatives to operate a two-tier structure where the COM and the supervisory board are present, side-by-side. Nevertheless, in Malta, the role of the supervisory board has been continuously questioned because in practice, members forming part of the co-operative tend to come from the same particular sector and therefore rarely possess the breadth of adequate management knowledge to man both the COM and the supervisory board. In fact, in the updated CSA (2001), such supervisory board was made optional.

Inevitably, moving on from the idea of mutualisation to practice involves extensive work. Clearly, there are certain legal requirements which such entities have to abide by during the mutualisation process. The rules listed in the CA on conversions of CPs and the regulatory procedures relating to mergers do not facilitate mutualisation as they are not specifically intended for the conversion of an LLC to a co-operative. Moreover, with reference to the merger rules which are again listed in the CA, it would be too difficult to operate a hybrid entity primarily because the structure of the co-operative differs from that of an LLC and generally is more complex. With respect to the dissolution and start-up regulatory procedures listed in the CA, it was found that such a process would be timely, costly and disruptive. By having a conversion process in force, the money, time and legal procedures would be simplified, as the company would remain a legal person during such a process.

For any type of business, securing affordable capital is the fundamental principle in aiding success. Upon affecting mutualisation, the LLC should determine how the capital and funding for the new infrastructure should be generated, whilst changes would also have to occur in terms of the equity of the entity. The equity of a co-operative differs from that of an LLC because shares in the former cannot be freely transferred and their value is not market based. In fact, repayment of shares is at par value and any appreciation in share value is not reflected in share prices. In addition, the ownership structure of co-operatives is widely dispersed among various members, thus preventing any concentration of ownership whilst ensuring that decisions are not taken by the largest shareholders but by all members, in their general interest (Pellervo Confederation of Finnish Co-operatives, 2000). Because surpluses are distributed to the members in proportion to business volume there is little, if any, advantage in holding more equity. As one would expect, in contrast to shares in an LLC, there is normally no market for co-operative stock.

ANALYSIS 1

THE ROSE-TINTED GLASSES VIEWPOINT – THE RATIONALE FOR MUTUALISATION

Passing the Green Light: Going beyond the Capital – The majority of respondents believed there is a direct correlation between employee participation and increased performance and participation. The primary reason for this is that, as illustrated in Figure 1, in a co-operative the user and the social aspects are given prominence, unlike in a company where the focus is on the financial and capital aspects. Sustaining this view, in a co-operative, members are rewarded according to their work contribution as the returns are distributed according to each member's turnover. Conversely in a company returns are distributed according to the amount of shares. In view of this, co-operative members would strive to collaborate and generate as much turnover as possible rather than struggle to increase their respective shareholding, as holding a large number of shares would not necessarily result in higher returns.

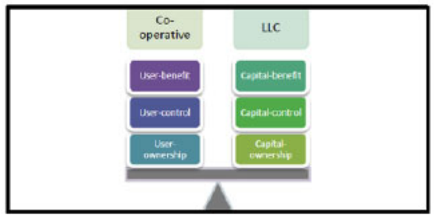

Figure 1: The economic and social dimensions of co-operatives

Mutualisation may also result in a better response to the needs of the individual members, provided that the primary intention of such members in having their company converted to a co-operative is that of genuinely achieving the seven co-operative principles and not for obtaining ulterior advantages such as tax savings.

THE BLACK LOOK – THE DIFFICULTIES ENCOUNTERED UPON MUTUALISATION

Every Cloud has a Silver Lining: Foregoing Speed for more Valuable Options – The majority of the respondents believed that although it is true that the co-operative model presents a bigger challenge than an LLC in terms of prolonged decision-making, it does not mean that such difficulty cannot be overcome by the right members who are willing to make the co-operative model work. In fact, as one interviewee contended, “If you want to go quickly, go alone; if you want to go far, go together” suggesting that in a co-operative model, one may need to sacrifice speed for more valuable alternatives.

Desiring Control over Democracy? – Respondents pointed out that the one-member one-vote principle may also result in unwillingness by the large LLC shareholders to convert to a co-operative. In such cases, being used to having control, such shareholders may, in turn, not want to be outbid by other members upon converting to a co-operative. However, there are ways of tackling the resistance, often understandable, of such shareholders. For instance, one may consider converting part of their shares into bonds, at reasonable rates of interest or rendering some of their share capital redeemable by its replacement into say, long-term preference shares or bonus shares and certificates

Feeling Browned Off: Incentive to Disinvest? – The current CSA states that “any moneys remaining after dissolution or liquidation of a co-operative… shall not be divided among the members… but shall be deposited into the Co-operative Societies Liquidation Account”. After a period of five years, such sums are transferred to the CCF (Government of Malta, 2001, Art. 104). In view of this ‘asset lock’ concept, interviewees agreed that co-operative members may be inclined to distribute all the profits made in each year. Such member inclination to have funds distributed may persist despite the tax exemption incentive that the government allows to co-operatives which is only applicable as long as surpluses are retained within the co-operative. One may therefore contend that the legal and fiscal frameworks are inconsistent, with the result that co-operative members do not have sufficient incentive to invest, but rather, an incentive to disinvest.

Indeed, this ‘asset lock’ concept probably originates from the social perspective of co-operatives, which may emphasize that any undistributed funds and assets are not to be taken up by the co-operative members but left for future generations. In other words, members are primarily entitled to benefit from the entity as long as they are members. Nevertheless, in order to seriously promote conversions, should not consideration be given to amending the regulatory framework in this regard?

To be concluded in the next issue

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

is Head & Senior Lecturer-Auditing & Financial Strategy at the Dept of

Accountancy, F.E.MA. University of Malta. His research publications focus on external/ internal auditing, its regulation and relationship to corporate governance and financial strategy, and the small-state dimension of the accountancy profession. He is also Rector's Delegate-Financial Affairs, Central Bank of Malta director and Accountancy Board member. Past positions included consultancies and directorships in companies, financial institutions, foundations, and co-operatives.

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.