

# **The Governance of Consumer Co-operatives: Rules and Realities**

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The governance of both companies and co-operatives has been the subject of considerable debate in recent years<sup>1</sup>. Both sectors have experienced some high profile problems with unwelcome press and public interest, and comparisons between the two have been and will continue to be made. The survival of the consumer co-operative movement may turn on its ability to persuade relevant parties - be they consumers, traders, bankers or law makers - that the co-operative model is a real alternative to the limited company. This paper looks at the way forward for consumer co-operatives, the role of the board of directors and methods of dealing with the distribution of day to day management control between the board and society executives.

The role of the board of directors - particularly its powers, responsibilities and relationship with shareholders, auditors and outside investors - has been at the heart of the corporate governance debate in both sectors. In the company sector, the Cadbury Report on the Financial Aspects of Corporate Governance placed great emphasis on the role of non-executive directors in the governance of large companies which, in the UK, have traditionally been dominated by executives. Both the Cadbury Report and the Co-operative Union Corporate Governance Working Group Report highlighted the role of the company or society chairman and secretary, the importance of board level participation in key decisions and the use of Audit Committees and Remuneration Committees as key elements of recommended practice<sup>2</sup>. Less attention has been paid to the legal framework surrounding these practices and to the role of the articles of association of a company or the rules of an industrial and provident society in defining the roles of directors, executives and others within the organisation<sup>3</sup>. This may be healthy as an obsession with legal structures may distract attention from the commercial realities and the importance of running an effective business. However, the dangers of adopting a constitution which then languishes in the top drawer of the secretary's desk until

a crisis emerges should be noted. If the management of the society has developed in a way not permitted by the rules, those involved may find themselves with legal responsibilities they had not anticipated. In addition, the society (and ultimately its members) may have to face bills for litigation as matters which could have been clarified in the rules have to be decided in the courts.

This paper explores some of the legal issues that arise. It has been written following a concern by one of the authors about the efficacy of society rules in dealing with the reality of the organisational structure of large scale modern consumer co-operatives<sup>4</sup>. It is also written shortly after a hostile take-over attempt from the company sector that has highlighted the long term interests of the movement in ensuring that the legal framework within which its societies operate is clear and robust, and will stand comparison with the limited company model. The paper considers the legally available methods for distributing power within UK consumer co-operatives and the choices that might be made by any particular society.

Three key features of consumer co-operatives must be borne in mind when considering these issues: they usually register as industrial and provident societies rather than companies; their origins lie in a large number of small co-operative societies which transferred assets to form the large national and regional businesses that dominate the UK consumer co-operative scene today<sup>5</sup>; and their boards of directors are wholly made up of elected representatives of the members who act as part time directors and are not required to have any business experience or training before joining the board. The society's executive managers are not usually directors.

The Industrial and Provident Societies Acts (IPSAs) 1965 to 1978 are essentially permissive on corporate governance issues, subject to the overriding requirement that the society is and remains a bona fide co-operative; that its rules address the issues listed in Schedule 1 of IPSA 1965 and the provisions in the legislation about the role of members in the general meeting<sup>6</sup>. The effects of any particular allocation of powers between different organs of the society are determined by the common law rules developed by the courts<sup>7</sup>. It is important at this point to note the distinction between the term "non-executive director" as used in relation to UK consumer co-operatives and in relation

to most companies. When used of companies, the term is used to describe an individual appointed to the board who is not an executive of the company and is therefore, in that sense at least, independent. However, such a director will often have considerable business and board experience. The intention is that he or she should have sufficient business experience or training and intellectual ability to be on the same level as the executives and thus realistically capable of acting as a check on their activities where necessary. The directors of a UK consumer co-operative, on the other hand, are non-executive; they are lay directors who depend on the expertise of the executives to run the business. This distinction will be relevant to a court assessment of the level of care and skill expected in the event of a negligence claim.

### **The corporate governance debate**

In the early 1990s issues of corporate governance came to prominence in both the company and the co-operative sectors. The Cadbury Report was a response to the company sector's "continuing concern about standards of financial reporting and accountability, heightened by BCCI, Maxwell and the controversy over directors' pay." The consumer co-operative movement established its own Working Group under the chairmanship of Professor Brian Harvey in response to Cadbury and also in response to problems of accountability in parts of the co-operative movement which had resulted in allegations of lack of competence and probity<sup>8</sup>. Neither report proposed legislative change but both had observations to make about the nature and role of the board of directors and its relationships with executive managers. It is important to bear in mind when comparing the two Codes of Best Practice on Corporate Governance that the Cadbury Report was addressing the needs of listed public companies against the background of existing provisions (the Companies Act 1985, the Financial Services Act 1986, the Insolvency Act 1986, standards agreed and applied by the accounting profession, the City Code on Take-overs and Mergers, and the Stock Exchange's "Yellow Book" on The Admission of Securities to Listing). The Co-operative Union Working Group,

on the other hand, was devising a system to operate in the absence of many of those regulatory structures. Despite this, there are many similarities between the two reports.

Both reports emphasise the duty of the board to "meet regularly, retain full and effective control over the company/society and monitor the executive management". Both recommend the adoption of a formal schedule of matters specifically reserved to the board for decision, to ensure that the direction and control of the society or company is firmly in its hands. Both stress the importance of training for directors and the availability of independent advice. The role of the Chairman of the board is emphasised: standing back from day to day matters and ensuring that the board is in full control of the society or company's affairs, as well as providing a countervailing force to the Chief Executive. Another feature is the use of audit and remuneration committees to ensure that directors play a leading role in the process of preparing financial statements, discussing them with auditors and determining the remuneration of the executives. Both recommend a need for transparency on the question of the total remuneration package of executives and for a limit on the length of executives' rolling contracts.

The main divergence between the reports arises from the difference in structure between consumer co-operatives and companies. Boards of large listed companies have traditionally been dominated by executive directors. The traditional board structure, and the difficulty of shareholders not having a voice at board level, resulted in the growth of boards made up mainly of executives. Thus a central issue is how the board can effectively control and monitor executive management when that group is dominant at board level. Consumer co-operatives, on the other hand, have developed from relatively small scale businesses operating at a local level, and controlled by an elected committee of members which would appoint employee managers to run the business. This structure was adapted to federal systems of delegate meetings and indirect election, but the election of part time "lay" directors who then appointed executives continued. As a result, the executives are not members of the board. Although the 1994 Report recommended that the Chief Executive and the Financial Controller should be made full board members, this proved unacceptable to the Co-operative Movement and

was removed from the 1995 Co-operative Code.

Thus in the co-operative the problem at board level is not the domination of the board by executives but rather their absence. There are contrasting approaches by the two committees. Cadbury emphasises the vital role of non-executive directors in contributing independent judgement on issues such as "strategy, performance, resources, including key appointments and standards of conduct"; their independence from management and the process of their appointment. The Co-operative Code, while emphasising the independence of the elected directors (with limits on the number of employees and others with business links, and a non-employee chairman), also emphasises the importance of training, independent advice and the possibility of co-opting outside non-executive directors for their business experience. However, whether on the board or not the influence of the executives (especially the Chief Executive) on a consumer co-operative is evident. Indeed, as the management expert at the apex of the hierarchy of employees, and the person with access to full information, one would expect no less. The advice put forward by this official and the views he or she expresses are bound to carry weight. If they did not do so, or if the board were regularly to ignore such advice and views, the board might have to consider how it could justify to the members the continuing cost of paying for such services. The question is whether the society's rules reflect this reality. Does the board devolve the management and conduct of the business to the executives? Should the rules acknowledge such a role for them? Can the executives be made legally liable on the basis of this role? What do the members want to happen? These questions are addressed below, but first we turn to the legislative framework within which societies operate.

## **The Act and the rules**

UK consumer co-operatives generally register under the IPSAs 1965 to 1978. This legislation provides a registered society with corporate personality and thus the capacity to hold property, sue and be sued, make contracts and generally operate as a separate legal entity in much the same way as a registered

company. It also limits the liability of the members to contribute in the event of the insolvency of the society to any amount not paid up on their shares<sup>9</sup>. The legislation is flexible on the question of governance. Registration under the IPSA 1965 is on the basis that the society complies with the requirement in section 1(2) of that Act that it be a "bona fide co-operative". The legislation provides no definition of that concept. However, one co-operative principle that is particularly relevant is the democratic control of the society by its members. The Registry of Friendly Societies, which is responsible for the registration process and has to be satisfied on this point, lays down that:

Control of the society will under its rules be vested in the members equally and not in accordance with their financial interest in the society. In general therefore the principle of 'one man one vote' must obtain.<sup>10</sup>

Similarly the 1995 version of the International Co-operative Alliance co-operative principles provides that:

Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives, members have equal voting rights, (one member, one vote), and co-operatives at other levels are also organised in a democratic manner.<sup>11</sup>

This gives the Registry power to question the degree of member control in a society and indirectly affects the role of the board. The process for electing board members, qualifications for election and the proportion of the board not representing members raise the democratic control principle. The principle also implies that certain functions (such as the amendment of rules and the receipt of financial statements) should remain with the general meeting<sup>12</sup> in addition to those conferred on the general meeting by statute - such as appointing and removing auditors, approving transfers of engagements, amalgamations or conversions and changing the name of the society<sup>13</sup>. The Registry Guidelines and the ICA principle both accept that democracy can be served by the current

system whereby the board is discouraged from becoming involved in day to day management but sets strategy and monitors performance.

The Act requires that the rules of all societies must deal with "the appointment and removal of a committee, by whatever name, and of managers or other officers and their respective powers and remuneration."<sup>14</sup> The combination of this requirement and the "bona fide co-operative" criterion allows the registry to test the rules against the central principle of democratic control by the members. However, subject to this broad limit, the question of the powers and responsibilities of elected directors, full time executives and the members in general meeting is a matter for the rules of each society. Once those rules have been registered they operate as a contract between the society and the members<sup>15</sup> and, so far as the powers of the board, the executives and the members in general meeting are concerned, they create organs of the society with mutually exclusive powers.

### **Rules and organs**

When considering this division of powers, it is useful to start with the Co-operative Union's Model Rules. Technically these rules are designed for use in registering new consumer co-operatives but they also operate as a benchmark for societies in revising their own rules. The current version (10th Edition of 1986, currently being revised) deals with these questions as follows:

The directors shall have full power to conduct the business of the society and to exercise on behalf of the society all the powers of the society not specifically required by these rules or otherwise to be exercised by the society in meeting. Without prejudice to the generality of the foregoing the directors shall have power in particular from time to time to engage, remove, or discharge the chief executive, the secretary of the society, managers and other employees and to fix their duties, salaries, or other remuneration and to require them to give security.

The secretary and the chief executive shall in all things act

under the direction and control of the directors. Without prejudice to the generality of the foregoing, the secretary shall prepare and send all returns to be made to the Registrar and cause to be made all the necessary entries in all registers required, by these rules or by the Act, to be kept by the society.

The directors may delegate any of the powers hereby given to them to committees consisting of such of their own number as they think fit who shall, in the functions entrusted to them, conform in all respects to the instructions given to them by the directors.

The equivalent in the companies acts says<sup>16</sup>:

The business of the company shall be managed by the directors who may exercise all the powers of the company. No alteration of the memorandum or articles and no such direction shall invalidate any prior act of the directors which would have been valid if that alteration had not been made or that direction had not been given. The powers given by this regulation shall not be limited by any special power given to the directors by the articles, and a meeting of directors at which a quorum is present may exercise all powers exercisable by the directors.

The directors may delegate any of their powers to any committee consisting of one or more directors. They may also delegate to any managing director or any director holding any other executive office such of their powers as they consider desirable to be exercised by him. Any such delegation may be made subject to any conditions the directors may impose, and either collaterally with or to the exclusion of their own powers and may be revoked or altered. Subject to any such conditions, the proceedings of a committee with two or more members shall be governed by the articles regulating the proceedings of directors so far as they are capable of applying.

The secretary shall be appointed by the directors for such

term, at such remuneration and upon such conditions as they may think fit; and any secretary so appointed may be removed by them.

After debate on the Report of the Corporate Governance Working Group, the 1995 Co-operative Congress agreed a Code of Best Practice. This commits the Co-operative Union to review the model rules so that they correctly reflect how societies are run, with<sup>17</sup>:

the clear specification of the particular duties and responsibilities of the directors and of the Chief Executive and the senior managers appointed under him/her; authorising directors to delegate the executive management of the society to the Chief Executive and the senior managers appointed under him/her; and making the Chief Executive and his/her senior managers responsible for the executive management of the society.

There is a debate as to whether the current Model Rules permit the extent of delegation practiced in consumer co-operatives today. What is beyond debate is that the rules should deal expressly with this issue of delegation, to make the members' decision-making powers and the responsibilities of directors and executives under the constitution clear beyond doubt.

The legislation and Common Law rules developed by the courts leave great discretion to those framing the rules of a society or the articles of a company as to the powers to be conferred on the board, the executives or the general meeting. However, the courts are clear about the effect of a division of powers along the lines of Table A or the Co-operative Union Model Rules.

After some dalliance in the last century with the idea that the general meeting of a company could overrule a board decision (as the members' meeting had supreme power which was merely delegated to the board or executives)<sup>18</sup>, the courts developed the organic theory of power distribution currently applied to companies<sup>19</sup>:

A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its

articles, be exercised by directors, certain other powers may be reserved for the shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders<sup>20</sup>.

This indicates that any body or person in whom powers are vested by the articles of a company has an autonomous right to exercise those powers without interference by other "organs". Thus if the articles confer power on the executives directly rather than providing for the delegation to the executives of the directors' powers, the executives will have the status of a separate organ and, within the scope of the powers defined in the rules subject only to the power of those authorised to remove them, will be free from intervention by either the general meeting or the board.

That this organic theory of power distribution also applies to industrial and provident societies has been confirmed by one Scottish court decision and two arbitration decisions of the Registrar of Friendly Societies from the 1950s<sup>21</sup>. The latter relied on the company law cases referred to above.

This legal position allows societies two options: direct allocation of power to the executives by the members via the rules; and delegation of power by the board in accordance with the rules (with, in each case, inclusion of appropriate powers in the contracts of senior executives). These two routes are both intended to reflect the way in which societies operate today and, in particular, the division between strategic decision making and day to day management. Under the first option, the rules would provide for the allocation of certain powers to the executive, thereby creating a separate "executive" organ within the constitution. The executive's role would be to conduct the business in accordance with the strategies and policies fixed by

the board, and subject to the supervision of the board. At present this method is used to allocate power to the board, but the rules could be amended to provide specifically for the direct allocation of certain powers to the executive. The role of the board could (and in the view of one of the authors should) include the duty to ensure that the business of the society is run in accordance with co-operative principles. That important duty seems to be conspicuously absent from the constitution at present. More important, the role of the board would be to set the policies and strategies and then to fix targets against which to monitor the performance of the executive. The board would be responsible for appointing and removing the executives, thereby being ultimately accountable to the members for control of the executive. Alternatively, the power to appoint other executives might be given to the chief executive.

The second option is confer full power on the board with authority to delegate. Delegation in line with the rules is arguably used by most societies at present. It involves conferring extensive powers on the board, which is then empowered to delegate to management. This system operates in most companies. It seems likely that it has operated within co-operative societies in the past by a relatively informal delegation to executives through provisions in their service contracts describing their responsibilities, board resolutions, and custom and practice over time. The importance of ensuring that any delegation is permitted by the rules arises from the application in this area of law of the maxim "delegatus non potest delegare". Powers already delegated by one body to another cannot be further delegated by the second body without authority from the first. Although the board is now generally regarded as an organ of the society rather than itself having powers delegated by the general meeting, it seems that the rules must permit the delegation of powers by the board. However, the power to conduct the society's business may well imply a power to delegate; power to appoint a Chief Executive and to define his or her duties may achieve this expressly<sup>21</sup>.

### **Drafting the rules**

If powers are allocated by the rules, the board will have no legal right to deal with matters allocated to the executive organ or

vice versa. The board's lack of power itself to perform the full executive function is unlikely to be a problem in practice. As long as the directors lack business expertise, they are unlikely to take on the executive function even in a crisis involving the sudden resignation or removal of senior executives. If certain defined functions are purely the responsibility of executives and will never be carried out by the board in any remotely probable situation it may be sensible for the rules to acknowledge this. It certainly avoids any argument that the board, having had certain functions conferred on it by rule, have wrongly delegated that function to the executives. Allocation of powers in the rules may also reduce the risk of "slippage" of power from the elected board to the executives. This might arise with either model if certain divisions of function were left to evolve by "custom and practice". This can lead to fuzziness and uncertainty about the roles of the board and the executives, a loss of direction and control of the society by the board and what Cadbury refers to as "misjudgements and possible illegal practices".

On the other hand, the second system, of delegation of powers by the board to the executives, allows considerable flexibility in varying the scope of the executives' responsibilities. There is no need for a rule amendment to change their powers, as members have already been excluded from decisions about power allocation from the board. Under either system it is important that the ultimate control and direction of the society remains with the board and that the executives are effectively monitored and supervised. This places a premium on the definition of the powers of the board and the executives to ensure that there will be no unforeseen situation in which a power which the board believed that it retained had in fact been ceded by rule to the executives. It is also vital that there be clarity about the role of each group to avoid disputes about who performs which function. If a system of delegation by the board under the rules is used but the rules do not adequately permit the delegation there will be a need for a rule amendment to deal with that problem.

Change will be difficult under either system. An executive's contract of service may so state his or her duties that certain changes in the allocation of functions between board and executives would amount to a breach of contract unless it was

first agreed by the individual involved. This would presumably only arise in a situation in which radical change was proposed and would depend on interpreting the functions allocated by the contract in the light of the executive's specific circumstances. However, if a Chief Executive's contract is expressly made subject to the society's rules, this problem may be overcome.

It is important that the wording used in drafting the rules and any other documents is precise and reflects the practice of the society. The use of wide language might lead to conflict about the demarcation of the functions of each organ. What is the difference between "supervision" or "monitoring" or "target setting" and "day to day management" or "conduct of the business"? Does the board retain "full and effective control" over the society (as the Corporate Governance Code of Practice requires) if "day to day management" is a function of the executive organ? These problems could be overcome by the use of a clear statement that executive functions are to be carried out subject to the policy and direction formulated by the board, and by a clear reservation of certain large scale decisions to the board. It is important that the danger of unintended "slippage" of powers to executives from the board is borne in mind. If full power is to be conferred on the board by the rules but some functions are to be delegated to executives, it is vital that the rules permit any delegation likely to be required.

The direct allocation of powers by the rules increases democratic control by the members, in that the original allocation of power and any later variation must have their approval. However, between rule changes there could be no variation by the elected directors of the powers conferred by rule on the appointed executives. Perhaps, when power is being allocated between two organs both ultimately answerable to the members, it is important that the members have a role. This favours the definition of the powers in the rules. Under both systems the board would appoint the executive.

The rules may be important for the perception of those dealing with the society. If the rules appear to give executive power to the board but the internal delegation in fact confers most such functions on the executives, there is a possibility that direct dealing with outsiders by the board could bind the society against the wishes of executives, and contrary to the internal delegation

system. However, if the powers are allocated by rule, outsiders might be more likely to ensure that they are dealing with the correct organ. This will not be a major issue if few outsiders read the rules before dealing with the society. It might, however, be important if the courts decided that the rules of constructive notice applied to societies. This could result in parties being deemed to know the contents of the rules and unable to deny them even if they were not in fact aware of them. In that case, the closer the allocation of functions described in the rules is to reality, the better for all concerned.

In drafting rules it is important to define correctly the role of each organ and to deal with unallocated or "residual powers". Thus the target setting, monitoring, co-operative and strategic roles of the board and executives should be clear, and there should be little overlap. If powers were all given to the board and then delegated to the executives, it would be clear that unallocated powers could be claimed by the board unless they had actually been delegated. However, in the past the "slippage of powers" by "custom and practice" without a clear decision has resulted in both Cadbury and the Co-operative Union reports recommending that a document should set out clearly the powers reserved to the board for decision. By implication this delegates all other powers to the executives. For the board to be protected from negligence liability for the delegation of powers to the executives or others, that delegation must be reasonable and in accordance with the rules.

The choice to use the society's rules, to allow delegation by the board of their powers under the rules or to draft executives' service contracts to allocate powers and duties should be based on the needs of a society for clarity, flexibility and transparency. As management techniques and systems change and societies grow and develop their businesses, these questions should be kept under constant review to ensure that the legal structures reflect the current needs of the organisation. It should be sufficiently easy to make changes to prevent the system on paper being overtaken by the system on the ground but the rules should be used to protect the interests of the members from arbitrary change and to avoid the undue accretion of power in particular hands. In striking this balance, judicious use can be made of the full range of techniques.

## **Possible liabilities of directors and executives**

We now turn to the legal consequences that might flow from "getting it wrong". How do society rules affect the liability of directors and executives? There are four aspects to this question: society contracts, negligence liability, fiduciary duties and statutory liability<sup>22</sup>. Perhaps the most obvious potential problem is whether contracts made by those purporting to act for the society are valid. If certain powers were vested in the board and no authority were delegated by them to executives or other employees to exercise those powers, any contract that the employee or executive made might be unenforceable by the society and the other party. The analysis used by the courts to determine this would involve a search for express actual authority, implied actual authority or apparent authority on the part of the society's agent. Express authority would exist if the rules conferred the necessary power on the board or another organ, and there was an unbroken chain of statements to an employee conferring the necessary authority. For example, suppose the board was given power in the rules to "conduct the business of the society" and to delegate its powers. If it stated (in writing or orally) that elements of that function were delegated to the Chief Executive with power for him or her to further delegate, then an employee charged with certain functions through that system would have express actual authority to make a contract to bind the society. Implied authority works similarly but, as the phrase suggests, would implicitly be passed down the chain from board level to the appropriate employee. It would usually be conferred by giving an employee certain functions to perform. Thus, appointing a buyer or a sales assistant would confer necessary powers on them. The scope of those powers would be defined by the needs of their job<sup>23</sup>.

In a case in which the express authority of an employee was limited, for example to a maximum figure, but outsiders were not aware of that, the court would still hold the society bound by a contract beyond the limit, if it were shown that someone with actual authority "represented" to the other party that the employee had the necessary authority<sup>24</sup>. The policy of the courts is to further commercial certainty and the security of transactions by upholding contracts where the outsider could reasonably

suppose that the "agent" had authority<sup>25</sup>. As a result of this approach societies are unlikely to face problems about the validity of contracts as a result of using one method rather than another to allocate powers between the board and the executives - so long as the rules in question are properly worded.

A second legal problem is possible negligence liability on the part of the board or senior executives. In the case of the board, questions of delegation are particularly important where an attempt is made to hold the directors liable in negligence for the fraud or other failings of senior executives. First, it is accepted that the scale of the business is relevant to the level of delegation to be expected and that the question is one for those running the business:

In one company, for instance, matters may normally be attended to by the manager or other members of the staff that in another company are attended to by the directors themselves. The larger the business carried on by the company the more numerous, and the more important, the matters that must of necessity be left to the managers, the accountants and the rest of the staff. The manner in which the work of the company is to be distributed between the board of directors and the staff is in truth a business matter to be decided on business lines<sup>26</sup>.

If, having regard to the needs of the business and the rules, particular duties can properly be left to the official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. Thus so long as the established procedures within the organisation are followed, those procedures are reasonable in the circumstances, are within the rules, and there is no evidence to suggest that the executives or other employees cannot be trusted, directors are entitled to trust officials to perform their duties honestly<sup>27</sup>.

How then does this relate to the allocation of responsibility between the board and the executives? Rules which allocate day to day management functions to the executives make a clear statement that the executives are responsible for those matters while equally imposing supervisory, monitoring and policy making responsibilities on the board. This approach makes it

clear what responsibility the directors and the executives have, and expressly authorises the directors to rely upon the executives. They still owe duties of care, however, and must show that care in monitoring the executives. But they will not find themselves liable for negligence for having delegated the conduct of the business to the executives.

The alternative model of conferring power to "conduct" or "manage" the business on the board could be argued to misstate the role of the board if this is interpreted as involving detailed day to day executive control. However, so long as the rules permit delegation of the directors' functions to executives and so long as the board does retain and exercise a controlling and supervisory role - receiving the information it needs, retaining the right to decide on major transactions, to hire and fire the Chief Executive and to set targets and policy and monitor executive performance, this model will achieve the same result. The case law suggests that those terms allow extensive delegation so long as the board does not abdicate a supervisory and "directing" role.

Modern case law suggests that the test for the negligence liability of directors is based on the behaviour expected of a reasonably diligent person with both that director's own personal level of skill, experience and knowledge and the level required of someone carrying out the function that he or she performs. Thus the level will be the higher of the two in any particular case<sup>28</sup>. This formulation allows the court to take account of the scale of the society's business and the non-executive and part time nature of the lay directors' role. In addition, the level of education and professional skill of individuals may add to the "baseline". Hence the distinction between the skills, knowledge and experience of a non-executive director of a large company and those of the lay director of a large consumer co-operative may affect the level of expertise expected by the courts.

The executives are also subject to legal liability for negligence. In their case this arises on the basis of the reliance placed upon them by the society and the implied term in their service contracts that they will perform to the level of a reasonably competent person fulfilling their role. Thus their liability will take account of their level of business experience and the full time and expert function that they are called upon to perform within the society<sup>29</sup>.

Unlike the Companies Acts, the IPSAs do not prohibit the insertion of a clause in the rules to limit the liability of directors. Such provisions might also be used to protect the Chief Executive or other executives from such liability, but whether such provisions are in the interests of the members of the society can be debated. On the one hand, the members are denied the right of redress against directors or executives, on the other, the possibility of such clauses may assist recruitment to those positions. However, in practice insurance to cover the liability of directors and officers is in the interests of the society as well as its directors and officers, and the insertion of such a clause should reduce the premium level.

The directors owe duties to the society of honesty and good faith. They must act in what they believe to be the society's best interests and not for any collateral purpose. They must avoid any conflict between their personal interest and their duty to the society and must refrain from making secret profits or exploiting for their own gain property or other assets of the society. It is also a breach of duty to use, for their own benefit, business opportunities of which they learn as directors. These obligations come with the office and are well established in the case law applicable to companies, which by analogy would apply to societies. The position of the senior executives of a society is more interesting. Under the present system the Chief Executive is not a director. However, his or her advice is influential in the board room. S/he will be present at all board meetings and will be responsible for presenting information, reports and proposals to the board as well as being at the apex of the society's management structure. How does this affect the duties of such officials towards the society? First, it is noteworthy that the concept of "fiduciary" duties which are owed by directors to the society originated from the relationship between the directors and the society; the courts are willing to impose such obligations in any situation in which a relationship of reliance and trust is actually to be found<sup>30</sup>.

Thus the fact that the society's board depends on its Chief Executive for information, advice and guidance may in itself give rise to fiduciary duties to act in good faith, avoid secret profits and ensure that there is no conflict between the duty of the executive to the society and his or her personal interests.

This can be deduced from the facts of the relationship. In addition, as an employee, duties of loyalty and honesty are implicit in the service contract<sup>31</sup>. When acting as agent, fiduciary duties will once again be owed by the executives to the society<sup>32</sup>. Thus the absence of formal appointment to the board should not free the executives from duties similar to those of directors but such duties ought to reflect the level of skill, time and information available to full time and highly paid executives in attending to the society's business. The resulting obligation will only be fulfilled by honest conduct and the disclosure of full information to the board before it agrees to any step in which the interests of the executive and those of the society may conflict<sup>33</sup>.

In addition to the obligations of executives under employment law, agency, and the law of fiduciaries, it is noteworthy that for the purpose of the Company Directors' Disqualification Act 1986 (CDDA), the courts have been willing to hold to account de facto directors who have not formally been appointed to the board. The statute also imposes liability on "shadow directors". A de facto director, while not properly appointed or formally registered as a director with the Registrar of Companies, acts as one and so is treated by the courts as having the duties and responsibilities of a director. A shadow director is defined as "a person in accordance with whose directions or instructions the directors of the company are accustomed to act"<sup>34</sup>.

While there is some dispute about whether CDDA can apply to industrial and provident societies, the concept of the de facto director could be applied. Thus a senior executive (particularly a chief executive) who claims or purports to act as a director may be treated as if s/he were a director despite the absence of formal board membership. Similarly, a Chief Executive whose "advice" is followed by the board so constantly and automatically as to become "directions" which they are accustomed to follow will be a shadow director and, as such, could be held liable for wrongful trading and, if CDDA were held to apply to societies, disqualified from acting as a director in the future.

## **Conclusion**

The corporate governance recommendations of the early 1990s emphasised the importance of the role of the board of directors

of both companies and consumer co-operative societies in retaining full control and direction of the organisation. This role differs from the function of executive management both in a company in which most directors are executives and in a society in which executives are not board members. The board should be in a position to control the organisation on behalf of the membership, and the composition of the board should reflect its control by members of the society. Having conformed to the requirements of the IPSAs in this respect, a society has great freedom to allocate functions in its rules or by delegation in line with the rules. The democratic principle suggests that members should be involved in the allocation of functions. However, the courts have established that, if an organ of the society is created by the rules, its powers can only be changed by rule amendment and decisions within its sphere cannot be made by any other organ. Thus, to confer powers on executives by rule gives them the status of an organ of the society. That may be a safeguard, because the need for rule amendment to change the position ensures that members are involved in any reallocation of powers, though it slows down the process of adaptation. On the other hand, a delegation of powers to executives by the board can be changed by board decision (subject to any possible breach of an executive's contract with the society).

An examination of the possible liability of directors and executives for negligence, breach of fiduciary duty or under legislation applying on insolvency, indicates that a failure to allocate powers in reality in accordance with the rules may cause problems for directors, if they wish to rely on a lawful and reasonable delegation as a defence in a negligence claim. The liability of executives is subject to the tendency of the courts to look to the reality of the situation and impose fiduciary liability on the basis of the executive's employment status, or the actual relationship of reliance by the board on the executive's advice. The statutory liability of an executive will be based on his or her status as a de facto or shadow director if this flows from the reality of the operation of the society at the highest level. Finally, it is important that the rules (or a system combining rule provisions with internal delegation and executive contracts) provide clarity about functions and is in line with the realities. This will ensure that no-one is held liable on the basis of functions

that they did not know they were intended to perform. It is important that the consistency of practice with the rules is kept constantly under review. To adopt a constitution and leave it in the top drawer until a crisis arises will benefit no-one - least of all the society's members.

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## Notes

- 1 See Cadbury, Report of the Committee on the Financial Aspects of Corporate Governance, 1992 ("Cadbury Report"); Co-operative Union Ltd., Report of the Corporate Governance Working Group, April 1994 ("1994 Co-operative Report") and Co-operative Union Ltd., Corporate Governance Code of Best Practice, July 1995 ("1995 Co-operative Code of Practice").
- 2 See Cadbury Code paras 1.1; 1.2; 1.4; 1.6; 3.3; & 4.3. and 1995 Co-operative Code of Practice paras 1, 3, 22, 23, 24 & 26.
- 3 This is particularly true of co-operatives although the passage of the Companies Act 1985 did give rise to a revised version of tables A to F (see Companies (Tables A to F) Regulations 1985 SI 1985 No 805) and many larger companies tend to adapt Table A provisions rather than using them as they stand as their own articles.
- 4 See: C. Mills, "Keeping the Executive in Check - Why Co-op Directors may be Acting Illegally" Co-operative News, 22nd October 1996, p4; and T. Knowles, "Controlling the Executive - Directors Must Look Beyond Rules" Co-operative News, 7th January 1997, p4.
- 5 See, for example, the historical accounts in: J. Birchall, Co-op: The Peoples' Business, Manchester University Press,

- 1994; and A. Bonner, British Co-operation, Co-operative Union, 1960.
- 6 Industrial and Provident Societies Act ("IPSA") 1965 section 1(1) & (2) and, for matters reserved to members eg sections 50 to 53 on transfers of engagements, amalgamations and conversions
  - 7 See sections 4 and 5(b) infra.
  - 8 For fuller details see Harvey B, "The Governance of Co-operative Societies" in Sheikh S. and Rees W. (eds.) Corporate Governance and Corporate Control pub. 1995 Cavendish Publications Ltd.
  - 9 IPSA 1965 section 3. The application of the ultra vires doctrine to acts outside the stated objects of the society and the absence of reform to other aspects of the legislation creates differences of detail between societies and companies in respect of eg executing contracts and the use of a seal. However, the key features of corporate personality and limited liability are shared by companies and societies.
  - 10 See Form 619 published by the Registry of Friendly Societies, London.
  - 11 International Co-operative Alliance, Statement on the Co-operative Identity, Manchester, September 1995.
  - 12 Which may be a delegate meeting if the society's rules so allow - section 74 IPSA 1965
  - 13 See IPSA 1965 Sections 5(3) (name of society); 50 to 53 (on transfers amalgamations and conversions); Schedule 1 paragraph 5 on ("the mode of.....altering....rules") and FIPSA 1968 sections 4 to 6 (appointment and removal of auditors).
  - 14 IPSA 1965 Schedule 1 para 6

- 15 IPSA 1965 section 14(1) and see *Re Compania de Electricidad de la Provincia de Buenos Aires Ltd* [1980] Ch 146 on the meaning of the similar provision in section 14 of Companies Act 1985 and earlier Companies Acts.
- 16 Section 8(1) Companies Act 1985 and Schedule to The Companies (Tables A to F) Regulations 1985 SI 1985 No. 805
- 17 *Co-operative Union Ltd, Corporate Governance Code of Best Practice*, First Edition, Manchester, July 1995, page 5 para 19.
- 18 See eg *Isle of Wight Railway v Tahourdin* (1883) 25 Ch D 320 and *Marshall's Valve Gear Co. v Manning Wardle & Co* [1909] 1 Ch 267
- 19 See *Quin & Axtens v Salmon* [1909] 1 Ch 311 and [1909] A.C. 442; *Shaw 7 Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 and *Breckland Group Holdings v London & Suffolk Properties* [1989] BCLC 100.
- 20 [1935] 2 KB 113 at 134 as quoted at page 149 of L.C.B. Gower, *Gower's Principles of Modern Company Law*, London, Sweet & Maxwell, 1992.
- 21 See: *Roper v Long Eaton Co-operative Society Ltd* (1952) Chief Registrar's Report Part 3 page 3; *Alexander v Duddy* (1956) S.C. 24 and *Ruddock v Watford Co-operative Society Ltd* (1956) Chief Registrar's Report Part 3 page 3.
- 22 See *Re County Palatine Loan and Discount Co, Cartmell's Case* (1874) 9 Ch App 691 as to the absence of inherent power to delegate and *Freeman and Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 and *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549 on the power to delegate implied by the Table A power to "manage" a company's business.
- 23 *Freeman & Lockyer v Buckhurst Park Properties (Mangal)*

- Ltd and Hely Hutchinson v Brayhead (above note 22).
- 24 Freeman & Lockyer (above)
- 25 See Rolled Steel Products (Holdings) Ltd v British Steel Corporation [1985] 3 All ER 52 and Halifax Building Society v Chamberlain Martin Spurgeon [1994] EGCS 41, Construction Law Digest 1994 11(4) at 21-23.
- 26 Re City Equitable Fire Assurance Co [1925] Ch 407.
- 27 Re City Equitable Fire Assurance Co [1925] Ch 407 and, as to a deception by executives who conceal matters from directors that are within the executive's sphere of activity, "Business cannot be carried on upon principles of distrust. Men in responsible positions must be trusted by those above them as well as those below them, until there is reason to distrust them. We agree that care and prudence do not involve distrust; but for a director acting honestly himself to be held legally liable for negligence in trusting officers under him not to conceal from him what they ought to report to him, appears to us to be laying too heavy a burden on honest businessmen." Re National Bank of Wales Ltd [1899] 2 Ch 629 at 673.
- 28 Norman v Theodore Goddard [1992] BCC 15 and Re D'Jan of London Ltd [1993] BCC 646
- 29 Lister v Romford Ice Cold Storage Co. Ltd. [1957] AC 555
- 30 "A person will be a fiduciary in his relationship with another when and in so far as that other is entitled to expect that he will act in that other's interests or (as in a partnership) in their joint interests, to the exclusion of his own several interest" P. Finn, "Fiduciary Law and the Modern Commercial World" in Mckendrick (ed) Commercial Aspects of Trusts and Fiduciary Obligations, Clarendon Press, Oxford 1992.
- 31 See Adamson v B & L Cleaning Services Ltd [1995] IRLR

193; *Faccenda Chicken Ltd v Fowler* [1987] Ch. 117; and *Boston Deep Sea Fishing and Ice Co. v Ansell* (1888) 39 Ch D 339.

32 See *Bank of Upper Canada v Bradshaw* (1897) LR 1 PC 479; *Lamb v Evans* [1893] 1Ch 218; and *Robb v Green* [1895] 2 QB 315.(33) See: *Fullwood v Hurley* [1928] 1 KB 498; *Boardman v Phipps* [1967] 2 AC 46; and *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 46

34 Section 741(2) of the Companies Act 1985 defines a shadow director. According to Millet J in *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 182:

“A de facto director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned only in the management of the company’s affairs or undertook tasks in relation to its business which can properly performed by a manager below board level ..... A shadow director, by contrast, does not claim or purport to act as a director. On the contrary he claims not to be a director. He lurks in the shadows sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself.” . See also: *Re Moorgate Metals Ltd* [1995] BCC 143; *Re Richborough Furniture Ltd* [1996] 1 BCLC 507 and *Secretary of State for Trade and Industry v Laing and Others* [1996] 2 BCLC 324.