

member benefits

democratic

community

**New Generation Co-operatives
and the Law in Saskatchewan**

CHAD HAAF
AND BRENDA STEFANSON

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education

autonomy

participation



UNIVERSITY OF
SASKATCHEWAN

Centre for the Study
of Co-operatives

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and the Law in Saskatchewan**

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Centre for the Study of Co-operatives
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Readers can find more information about this subject in another research paper prepared by Chad Haaf and available for sale from the Centre for the Study of Co-operatives titled *A Comparison of New Generation Co-operative Legislation in Alberta, Saskatchewan, and Manitoba*. The Centre has also published a binder of materials covering many aspects of New Generation Co-operatives titled *Resource Materials for Business Development Professionals and Agricultural Producers*, as well as a number of other booklets on the topic. Details about how to contact the Centre are on the copyright page.

New Generation Co-operatives

An Introduction

BRENDA STEFANSON

The New Generation Co-operative (NGC) concept is attracting attention as a means of increasing farm income and offsetting some of the negative impacts of recent changes in agriculture. Saskatchewan has new legislation that makes it possible to achieve all the benefits of the NGC model. The purpose of this introduction is to provide a brief summary of the characteristics of the New Generation Co-operative model.

The agricultural system is undergoing dramatic change. Changes in technology, institutional structures, regulations, the integration of value chains, and the globalization of agricultural markets are resulting in an integrated system in which the family farm is increasingly interwoven with the food distribution chain. Consumers today are increasingly demanding choice, quality, consistency, and value. Producers and the food industry are capable of providing what the consumer wants, but only if changes are made to the structure of agriculture. Advances in biotechnology and information technology make it possible to engineer food at every level, from farm gate to dinner plate. Biotechnology enables the isolation and incorporation of specific traits in plants and animals, effectively providing what the consumer wants. Information technology enables the industry to monitor consumer preferences and track products throughout the value chain, incorporating this information at all levels.

These technological changes also necessitate changes in marketing channels. The preservation of product identity is required to assure that the character-specific product reaches the consumer who is demanding it. Commodity markets (where products are gathered, mixed, and passed to processors who produce generic food goods) are not structured to accommodate the designer products of the modern food chain. More direct marketing channels, such as production contracts and vertical integration, are required to maintain the identity of genetically altered or organically grown agricultural products. Experts predict that the vertical integration of marketing channels will continue to escalate.

Another change that profoundly affects Saskatchewan farmers is the loss of the WGTA, or “Crow” subsidy. Farmers now shoulder the full cost of transporting their raw commodities to distant ports. Saskatchewan producers—half-way between Vancouver and Thunder Bay—have witnessed the result of this change. The net effect of all these changes is obvious to the farmers: lower returns for primary production. Farmers have done everything in their power to adjust to these changes. They have increased their acreage, diversified into special crops and livestock, and reduced costs wherever possible. New strategies, different organizational structures, and new attitudes are necessary if Saskatchewan agriculture is to survive.

Farmers can exploit their position within a vertically integrated agricultural system if they retain ownership of their products beyond the farm gate and invest in ventures that add value to those products. The New Generation Co-operative model offers farmers the opportunity to join together to move up the value chain and capture some of the profits. The success of this structure has been witnessed in Minnesota and North Dakota, where sugar beet (since 1974), bison, and durum (since 1990) producers have owned processing facilities and gained returns, in the form of dividends, from those ventures. Other examples of NGCs include facilities to process organic grains, soybeans, eggs, specialty cheeses, and edible beans.

The NGC structure is unique, particularly in its share structure, which is characterized by three classes of shares: membership, equity, and preferred. The membership share gives the holder the right to vote and to

purchase equity shares, which are attached to delivery rights. NGCs are organized to add value to an agricultural commodity such as bison or durum. Only producers of the commodity can hold membership shares, thereby ensuring that control of the venture remains in the hands of the producers. NGCs adhere to the basic principles of co-operation set out by the Rochdale Society of Equitable Pioneers in 1844: democratic control, and one member, one vote. Voting rights are tied to membership, independent of the level of investment. This ensures that no one member can exercise control over the group.

The equity share allocates delivery rights to the co-operative and raises the capital necessary for establishing the venture. Each equity share purchased gives the member the right and the obligation to deliver one unit of product (i.e., one bison or one bushel of durum) to the co-operative for processing. This is a two-way contract: the member is committed to deliver, and the co-operative is committed to take delivery. The contract sets out the standards for quality, and delivery is regulated to keep the plant running at capacity. In today's market, quality and consistency are extremely important. Therefore, the delivery contract sets out specific quality conditions. The co-operative can reject deliveries if the products do not meet these quality standards. Rarely is this necessary, however, because the members contract only a portion of their production to the co-op, and they select the highest quality product for delivery to their own processing plant. In the event that a member is unable or unwilling to make delivery, the co-operative will purchase the amount of the product covered by the contract and charge the cost towards the member's equity account. This strategy ensures that the co-op will have a consistent quality and quantity of product, and can focus on developing markets.

The purchase of delivery rights (equity shares) represents a significant investment on behalf of producer-members and a significant equity infusion for the co-operative. In 1990, for example, the North American Bison Cooperative sold 180 membership shares at a cost of US\$100 each. These 180 members purchased a minimum of ten equity shares at US\$250 each, a minimum investment of US\$2500. The sale of delivery rights is a mechanism for securing start-up capital. Member equity investment represents 35–50 percent of the start-up costs. The obvious benefit to the co-operative

of low debt is augmented by the benefit of member commitment. The loyalty of members is locked in through the contract and the investment; the member has made a large investment and will act to ensure the success of the venture. The equity shares are tradeable and transferable. The shares have value and can be sold to other producers with the approval of the board of directors. Shares can be passed on to the next generation along with other assets.

The preferred share allows the co-operative to invite investment from non-producers. Preferred shareholders cannot vote except in certain circumstances, as described in the legislation. The preferred share offers a limited, fixed rate of return. Communities and non-producers choose to purchase preferred shares because they want to support development in their communities and encourage job and wealth creation close to home.

NGCs are select- or closed-membership co-operatives. A feasibility study determines the most efficient plant size, which, in turn, determines the amount of product the plant can accept. Equity shares are issued to members based on the capacity of the plant. Once the allotment of shares is sold, the membership is closed. New members will be accepted and additional equity shares issued if the plant expands. Comprehensive feasibility studies and business plans are critical to the success of these ventures. NGCs often operate in niche markets, where it is important to understand the type, quality, and quantity of product demanded. A clear understanding of markets and consumers has enabled these ventures to serve markets that large corporations cannot.

Although some co-operatives have actually increased the price of the raw commodity, the primary economic benefit to members flows from the dividends of processing and marketing. Producers are paid market price for the delivery of their raw commodity, but because they own the processing plant, they gain returns from processing activities as well. They have vertically integrated upwards in the food industry and captured the returns to primary and secondary processing.

The vertically integrated structure encourages the effective use of market and production information. The structure enables market information to be combined with local production knowledge to produce the type of product required to serve lucrative niche markets.

The term New Generation Co-operative is not a magic structure, and it should not be applied to ventures that do not incorporate the strategies of two-way delivery contracts and high member equity investment. Producers must be willing to commit time to the development process, to invest sufficient equity to capitalize the project, and to contract product to supply the plant, or the project will not succeed. If producers are not committed through delivery contracts and investment, it will be difficult to leverage other investment funds, either as debt or outside investment capital. If the two-way contracts are replaced with softer delivery agreements, the risks to the co-operative increase because it will not have a secure supply of product.

New Generation Co-operatives and the Law in Saskatchewan

CHAD HAAF

Co-operative law in Saskatchewan underwent a significant change with the introduction of the *New Generation Co-operatives Act* (hereinafter the *Act*) in January 2000. The *Act* provides a mechanism for agricultural producers to join together to jointly market and/or process their products. New Generation Co-operatives (NGCs) have been formed in the US as a way for farmers to increase their share of the consumer dollar and as a means of revitalizing rural areas. Yet despite their success in the US, they have been slow to develop in Canada. The introduction of legislation specifically accommodating the main elements of the NGC is expected to increase the adoption of the model in Canada.

The purpose of this paper is to highlight the key features of the *New Generation Co-operatives Act* and to explain their importance. The paper is designed to be used by individuals who wish to create an NGC and thus take advantage of its strengths as a business vehicle. The paper will focus primarily on the differences between the *New Generation Co-operatives Act* and the more general *Co-operatives Act*. It is assumed that readers have a basic knowledge of the *Co-operatives Act* and of co-operatives.*

* Due to the relative newness of the *New Generation Co-operatives Act*, there are few sources that examine the differences between this *Act* and the *Co-operatives Act*. A good source of information is the speaking notes and outline presented by J.J. Dierker, QC, at the New Generation Co-operatives Experts Workshop of March 2001, available in the binder of materials circulated to workshop participants.

Although the *NGC Act* contains a number of elements that distinguish it from the *Co-operatives Act*, these elements are largely concentrated in four areas: articles and by-laws; marketing contracts; finance; and fair dealing. This paper highlights the relevant points in each of these areas, as well as offering a broader picture of the *NGC Act*.

Articles and By-Laws

Every corporation and co-operative must set parameters and guidelines for its governance through articles and by-laws. The *New Generation Co-operatives Act* addresses a number of important issues surrounding the articles and by-laws and provides direction when applicable. These fall into the following areas:

- The dividends on common shares must have a maximum value set in the articles (s.6(2)(l)).
- The co-operative must indicate whether it intends to issue preferred shares, and it must delineate the rights and restrictions ascribed to each class of shares (s.6(2)(d)).
- The articles may specify the rules for distribution of property on dissolution of the co-op (s.6(2)(m)). The *Act* further clarifies this issue by allowing for the distribution to members either equally or on the basis of patronage (s.262(12)).
- The members' power to manage the co-operative and to restrict the authority of the directors may be established in the articles (s.6(2)(n)).

The *NGC Act* also contains some unique features:

- The *Act* generally provides for more flexible share transferability. The transfer rights of common shares and s.35 membership-only preferred shares, however, must be listed in the by-laws as per s.7(1)(a)(iii).
- The by-laws of the co-operative may establish the obligation of the members to provide goods or to use its services where this is a condition of membership (s.7(1)(a)(v)).

Marketing Contracts

A key element in co-operative organizations is the relationship between the co-operative and its members. In an NGC, this relationship takes form and is rooted in the marketing or supply contract, which is an agreement with the members to sell or deliver raw goods for sale, processing, or preparation. The marketing contract is critical to the operation of an NGC, since it determines the supply of the raw product that is marketed and/or processed by the co-operative. The agreement may outline special characteristics and/or relevant details.

The *NGC Act* also provides additional direction to the relationship between the co-operative and its members. The co-operative may act as an agent on behalf of the members (s.215(2)(b)), and hold the goods in pools (s.215(4)). If the co-operative holds the goods, there is no transfer of title (s.215(2)(a)). Members' goods in the co-operative's possession are also precluded from liability attaching on behalf of the co-operative's creditors (s.215(3)). Other significant details of the contract may include the payment to members for goods sold or delivered, the manner of charging for the co-operative's expenditures, and the deduction of a loan to the co-operative or money used to buy shares in it (s.215(5)). The co-operative may also advance part payment to the members for goods delivered, or to be delivered, as per the contract (s.214(1)).

Because the *Act* provides NGCs a high degree of flexibility in arranging them, marketing contracts can take many forms and be structured in numerous ways. The articles and by-laws may house the marketing contract between the co-operative and the member (s.6(6); s.7(2)), or the contract may exist as a separate entity as laid out in s.215. Where it is foreseen that an ongoing relationship with little deviation from the initial terms will exist, the contract may be built into the articles or by-laws. Contracts located in the articles are strongly entrenched. Any alteration of the contract would constitute a fundamental change to the articles and trigger the dissenter's rights of the members and preferred shareholders (s.259). Marketing contracts in the by-laws allow for increased flexibility, though modifications face significant restrictions. Any change to the terms of a marketing contract in the by-laws, including termination, would require a special res-

olution by the membership (s.201(1)). A marketing contract peripheral to the articles and by-laws offers the most flexibility. It may be structured as a uniform contract for all members, or customized for each particular member, which would make it easier to effect changes to the contract since consent need only come from the NGC and the individual member. Changing the contracts of certain members and not others, however, can give rise to issues of fairness.

In the event of a breach of the marketing contract, the *NGC Act* allows for several remedies. The innocent party is entitled to seek an injunction preventing further breaches (s.214(2)(a)), which is a particularly notable remedy because it enables the innocent party to bypass the burden of proving irreparable harm. Also available is any equitable relief specified in the contract and specific performance (s.214(2)(b), (c)). Even member withdrawal does not discharge the duty to perform. The wide range of remedies at the disposal of the innocent party reinforces the NGC's emphasis on performance of the contract and consistency in the delivery and acceptance of product.

Financing

The financing of a co-operative often draws on numerous resources, including the assumption of debt and the issuance of shares. The New Generation Co-operative identifies its membership and obtains capital for its operations through its financing structure. The NGC share scheme is dictated by its capital requirements. Each co-operative will have common shares—essentially membership shares—but it may also issue preferred shares in any number of classes (s.6(2)(d)). Common shares are restricted to members only (s.243(1)(g)) and are sold at a par value (s.47(3)) established in the articles (s.6(2)(b)). Common shares do not represent a significant source of capital for the NGC because the members' required contribution is typically set quite low.

Preferred shares are a more valuable source of capital for New Generation Co-operatives, largely because of their flexibility and versatility. Of particular importance are the delivery right shares, which are at the core of the NGC model and are described in more detail below.

An advantage of preferred shares is that their classes may be structured with different rights and limitations, subject of course to the *Act*. Important elements in a share class include voting rights at the directors' election (s.34(1)) and the availability of shares to the public (s.33(1)(a)). Public preferred shares are pivotal because they allow the community to support the venture and to indirectly participate in developing the local economy. These shares also make the NGC accessible to a much wider pool of investors, though a public offering requires full securities disclosure.

Preemptive rights and the use of proxies are two other features of the *NGC Act* open to preferred shareholders. Preemptive rights established in the articles (s.37(1)) allow shareholders the first right to any new offering of their respective class, up to the percentage of interest held prior to its offering (s.37(2)). These rights provide preferred shareholders some certainty of maintaining their interest in the NGC in the event of another offering, thus discouraging squeeze-outs by the board. Preferred shareholders who have the right to vote may also use proxies to represent them at meetings. This right does not extend, however, to common shares (s.217(1); s.216(2)).

Although preferred shares may be structured with a number of rights and restrictions, the *NGC Act* establishes specific guidelines. Preferred shares are issued with stated capital and maintain a stated capital account (s.48(1)). Both stated capital and par value are subject to reduction, but only through special resolutions by members and affected preferred shareholders (s.61(1)). Limitations are placed on any individual shareholder's interest, which is intended to prevent excessive power being held in the hands of single parties and to ensure membership control, thus maintaining the cooperative character. In s.40(1)(a), a preferred share class with director voting rights attached has an interest ceiling of 10 percent on each holder, and the directors elected by preferred shareholders cannot exceed 20 percent of the board (s.34(2)). All other classes of preferred shares are limited to 25 percent interest by one holder (s.40(1)(b)). Preferred shares are fully transferable, although transfers still require the board's consent (s.66(b)).

Within the preferred share category, the *NGC Act* specifically identifies and makes available an important class of member-only shares—delivery-right shares—in s.35. These shares are intrinsically connected

to the marketing contract, together forming the unique relationship between the NGC and its members. The marketing contract establishes the obligation between the member and the co-operative, while s.35 shares delineate the scope of the duty. S.35 shares serve two key purposes: they provide a large share of the capital for the NGC and they are the primary means for earnings participation. Members who subscribe to such shares are obligated to provide or deliver a specified good or service, or have the right to receive a good or service in accordance with the contract between themselves and the co-operative (s.35(d)). This represents a critical departure from a traditional co-operative, where patronage is generally voluntary. In the NGC, the supply of product from the members is predetermined quantitatively and usually qualitatively, and performance of the obligation is mandatory.

S.35 shares are also closely linked to the processing emphasis of an NGC. Typically, each share represents one unit of product the member must deliver to the co-operative. The obligation is usually different for each member, depending upon the number of shares owned. However, it is common for minimums and maximums to be imposed on s.35 share interests, an action undertaken to maintain a certain degree of homogeneity among members. The price of the share is established by first determining the optimal efficiency of the processing facility and the product necessary to meet that capacity. The capital required for operational start-up is then divided by the amount of product needed for processing; the resulting figure is the share price. Due to the fixed number of units the facility can accommodate, and the s.35 shares based on those units, membership is restricted. Thus, with s.35 shares, marrying the producer's capital contribution to delivery rights and obligations ensures a consistent supply of product for the co-op and a guaranteed market for the producer, with the producer's patronage being directly proportionate to his or her equity.

Several additional rights and restrictions apply to s.35 shares. The shares must belong to a preferred share class (s.35(b)), are accessible only to members (s.35(a)), and the articles cannot be amended to allow nonmembers to hold them (s.243(1)(g)). In addition, s.35 shares carry no voting rights on director elections (s.35(c)), but shareholders may vote on the basis of their membership. Special participation rights, enumerated in s.35(e), allow

holders to receive the surplus by way of patronage dividends or bonuses, to receive reserve amounts through dividends, and to have access to the remaining property on the co-operative's dissolution. The profits from the processing operation are usually distributed through the patronage dividends of s.35 shares. Like standard preferred shares, s.35 shares are fully transferable (s.66(a)), subject only to the board's approval (s.68).

The *Act* also provides guidelines for the regulatory bodies governing securities. Any co-operative issuing or trading securities initially falls under the jurisdiction of the Co-operative Securities Board (s.318(1)), which has the option to direct the matter to the Saskatchewan Securities Commission (s.317(2)). Conversely, under s.317(3), the co-operative itself may elect to be governed by the commission. Any securities issuance or trade for membership shares, or exchanges involving bonds or debentures with financial and governmental bodies, are exempted from the jurisdiction of the Co-operative Securities Board (s.320(1)), although each co-operative must file a disclosure document with the board for a securities offering (s.319(4)).

Fair Dealing

The *NGC Act* addresses extensively the termination of the relationship between the NGC and its members, and the standards for fair dealing. When the relationship between the co-operative and a member has become untenable, the *Act* provides a number of means for members to leave the organization: withdrawal; expulsion by the board; or expulsion by members. In the event that a member voluntarily withdraws, the *Act* outlines proper conduct and procedure. A member may withdraw if notice is given (s.209(1)), and the co-operative has five years from the date of the notice to buy back the shares. Common shares are purchased at par value and the s.35 shares are purchased at the formula price set in the articles. If the articles are silent in this regard, then the buy back must be at fair market value (s.209(2)(a)). Loans to the co-op by the member must be repaid, along with any amount held to the member's credit (s.209(2)(b)). Even though the member has withdrawn from the co-op, however, he or she is still obligated to fulfill the marketing contract (subject to the board's discretion) until another suitable buyer can be found to take on the obligation (s.209(4)).

The *Act* provides a similar process for dealing with member expulsion from the co-operative. Termination of membership by the board requires a special resolution (s.210(2)), while expulsion at the hands of the members must be approved by a two-thirds majority (s.211(1)(b)). Upon an effective expulsion, the marketing contract between the member and the co-operative is terminated (s.210(8)(a)). However, the co-operative must buy back all s.35 shares at the price described in the articles, or at fair market value if the articles are silent (s.210(7)(a)(ii); s.211(2)(c)). The co-operative is also obligated to purchase the member's common shares at par value, and pay out all outstanding loans to the member or credit held on the member's behalf (s.210(7)(a)(ii); s.210(7)(b); s.211(2)(c)). The *NGC Act* ensures members are dealt with in a fair manner and includes an appeals process to the registrar (s.212).

If a co-operative resolves to pursue fundamental change, the *NGC Act* addresses this in the form of dissenter's rights. Members or preferred shareholders have standing to dissent where the co-operative moves to: amend the articles in such a way that it will adversely affect their interest or adjust the restrictions on business activities; amalgamate; seek a continuance; or drastically alter its property holdings (s.259(1)). Preferred shareholders affected by an article amendment as per s.246 may dissent on significantly broader grounds, outlined in s.243 and s.244 (s.259(2)). This right to dissent is excluded on issues of a co-operative name change and/or an increase in the number of directors. A dissenting member or preferred shareholder may object to a proposed resolution (s.259(3)); if the resolution passes, the objection is deemed to be notice of intent to withdraw (s.259(4)). Once the impugned resolution has passed, the dissenting party may issue an actual notice to the co-operative. This notice demands withdrawal, payment of fair market value for common shares, repayment of any other interest outstanding, and the set price as established in the articles, or fair market value, on preferred shares (s.259(6)(c)). The co-operative is then obligated to pay the applicable amounts.

Joint membership provisions in the *Act* protect the co-operative from any shortages and allow producers to distribute some of the risk and obligations of marketing contracts. A membership jointly held places full rights and responsibilities of membership upon all parties (s.70(1)(a)). In addition, the *Act* stipulates that all parties holding a membership jointly

have joint and several liability on all obligations respecting the membership (s.70(3)(b)).

Memberships and their respective rights are given more flexibility in the *NGC Act* than in traditional co-operatives. Each membership is fully transferable (s.66(a)) subject to the directors' approval (s.68). On the death of a member, the membership can be transferred to a beneficiary or executor regardless of their membership status (s.69(3)(a)), but although the beneficiary may enjoy most member rights and honour the obligations, voting is excluded (s.69(11)). The membership may also be subject to certain additional restraints. For example, the co-operative has the right to put a lien on a member's interest where monies payable to the co-operative pursuant to the articles or by-laws are considered debt (s.64); this practice can also apply to other types of shares (s.65).

In terms of dissolution, the *NGC Act* stays fairly true to the *Co-operatives Act*. A key difference, however, is worth noting. The *NGC Act* specifies that the articles may indicate how the property of the co-operative is to be distributed upon dissolution (s.6(2)(m)). In the event of the articles being silent, the property is to be distributed to a charity, another co-operative, or anyone the registrar designates (s.262(13),(8)).

Conclusion

The New Generation Co-operative holds promise as an effective vehicle for agricultural producers to move beyond pure production to access processing and preparation markets. The template for the NGC model is specifically outlined in the recently legislated *New Generation Co-operatives Act*, which details the items that distinguish it as a distinct business organization: the articles and by-laws, marketing contracts, the method of financing, and fair dealing. Each element contributes to the NGC's unique character and gives it the capacity to more efficiently provide producers the opportunity to move up the food value chain. Showing significant potential for producers and practitioners on a corporate level, the NGC model is also another resource to be tapped in the future development of rural Saskatchewan.

- HAAF AND STEFANSON