Tele-learning Session:

Investment Shares in Co-ops

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Introduction & Historical Context, Laird Hunter:

In his seminal article from 1937 "The Nature of the Firm," the economist Robert Corse argues the main reason why a company exists - as opposed to individual buyers and sellers making ad hoc deals at every stage of production - is because the company minimizes the transaction costs of coordinating most applicable and particular activities. Bringing the capital providers people in-house - people who would otherwise act as their own agents - reduces the costs of negotiating a separate contract for each exchange transaction.

Since Corse, traditional finance theorists and economists have asserted that companies:

(a) increase the availability of capital for investment;
(b) allow investors to spread the risk by purchasing small and easily marketable shares in small quantities and prices; and
(c) provide a way of imposing effective management strategies on large organizations.

And in the traditional approach the reduction in transaction costs that companies deliver has to be balanced by the "hierarchy cost" of managers ignoring dispersed market information.

This approach has led to the intricate and complex world of corporate finance and the intersection of business corporations' statutes and securities legislation. The two principal underlying assumptions are that control is a reflection of capital holding - one share equals one vote, and that the residual owners of a company are the capital holders.

Finance regulation of traditional capital-driven companies is the stuff of the whole approach and industry of reducing transaction costs, controlling management, giving priority to one share - one vote and protecting capital in the final instance, whether through priorities in creditor remedies or on winding-up.

But this entire approach is more than slightly out of kilter when it comes to the cooperative as a form of company. Distinct features of the cooperative pose special problems when financing for that form of enterprise is sought. The most important of these are the principles of limited return on capital and of one person, one vote. Because the ownership of shares or membership in a cooperative, Terry Snyder weighted voting power or the opportunity for a high return on capital, investment in cooperative securities is seen to be generally less financially attractive than investments in securities in traditional share capital corporations.

That traditional internal financing of cooperatives has been through shares, fees and loans to members. In addition, cooperatives have traditionally been viewed as not to be formed to earn a profit but to provide services at cost, and that surplus represents funds belonging to the members and is neither the income of the cooperative nor available to capital providers. In this respect, retained earnings of cooperatives form an important source of financing of those cooperatives will operate at a profit, in contrast to direct charge cooperatives.

This conception is coupled with one of the fundamental characteristics of a cooperative, and a major distinguishing feature from share capital enterprises, the requirement that any surplus after provision has been made for reserves and dividends as required or authorized is to be distributed to the members in proportion to their patronage to the cooperative. In many instances it should be noted that this allocation does not require that the dividend be actually paid to the members; it may be "allocated, credited or paid" to them. This sets the stage to enable the Cooperative to retain the patronage dividend as a compulsory loan from the members.

Increasingly as cooperatives engage in a broader marketplace, the contrast between the rights and privileges of capital providers in the traditional sense are balanced and measured against the traditional theory of cooperative organization. The range of statutory provisions in the various cooperative statutes in Canada today reflects this tension.

When examining the particular details of this "external financing" in any statutory context, it is well to bear in mind that while in many respects external financing for cooperatives parallels the ordinary business corporation, the nature of the rights and entitlements to provide security by way of traditional corporate means is accommodated against the fundamental bases of cooperative organization – one member one vote and limited return on capital.

Amendments to cooperative legislation in the last 20 years reflect the attempt at this accommodation.

Investing in co-ops is seen as less desirable.
This creates a tension, between capital and cooperation.

The co-op approach to financing has to be balanced with 1 member-1 vote and limited return on capital. The various different Acts express this tension. The various different Acts have a continuum of models.

People need to look under their particular Act to see what it says.
The PEI Act is 37 pages long; the federal Act is over 200 pages. The others are in between. The details are trying to balance investor rights with membership interests.

Brian's response: the idea of reduced transaction costs in a corporation: dealing with multiple small investments in a co-op: this adds to the transaction costs that we have to carry in a co-op environment. We find this with the Solar Share Co-op. One thing which makes co-op shares less attractive is that we cannot add capital gains tax exemption – which puts co-ops at a huge disadvantage in trying to attract capital.

My comments primarily reflect the Ontario Co-operative Corporations Act; Laird to some degree on Alberta. The legislation in other provinces is different and specific advice from a lawyer familiar with your provincial legislation is essential.

1. What Are Shares?

Only share capital co-ops have shares – non-profits (generally) do not.

"Share" suggests a share of the ownership of the business.

Traditional common shares in business corporations demonstrate that: if 100 common shares are issued, and you hold ten, on dissolution, you would be entitled to 10% of the net assets of the corporation.

2. Raising Capital

Businesses, including co-operatives, obtain the capital they need by borrowing – issuing debt – or from investors – issuing shares.

Debt instruments, such as promissory notes, debentures, and bonds, pay interest and are repayable, normally on a specified date, or on demand. Once repaid, the creditor has no further interest in the corporation or its assets.

Shares, on the other hand, entitle the holder to dividends indefinitely, and to a share of the net assets of the corporation on dissolution.

However, debt instruments can be structured to look more like shares, and shares can be structured to look more like debt.

It all depends upon the rights and privileges that attach to the shares, as set out in the Articles.

3. Share Value

In an ordinary business corporation, (at least in a publicly traded corporation) the share value is determined by the market value of the business, ultimately as reflected in the portion of the net assets of the corporation on dissolution to be paid to the shareholder.

As the fortunes of the business ebb and flow, and assuming there is a market for the shares, the share price fluctuates.

In co-operatives, at least in Ontario, the share value is, essentially, fixed at its par value, normally the price paid to purchase the share. There's certainly no market to determine any other value.

There has been a push to change from par values in Ont., but this has not been enacted. Having par value shares can be a challenge; can create a challenge to de-mutualize to distribute the net value of the business back to the members. This has been addressed in Ontario by sometimes allowing Articles of Amendment to increase the par value of membership share. The Co-operators has done this as well, to enable an increase in value over par for the new members; since then they've been willing to accept new members.

6. Designing Co-operative Capital

Co-ops generally have 2 classes of shares: membership shares & preference, or investment shares. Membership shares generally have a nominal value. Dividends on member shares are limited to bank prime + 2%. Some co-ops only have member shares. If you have preferred shares or investor shares, these are the ones designed for investment; to financially support the co-op.

Designing co-op capital is a bit of an art.

A co-operative's directors will have to decide what particular set of preferences, rights and privileges attached to preference shares will suffice to raise the required amount of capital.

It helps to already have some knowledge of what perspective members/investors are likely to find attractive.

It is certainly not easy to change what is on offer once marketing has begun (this requires going back to the original investors) – offering to sweeten a deal could see the offering oversubscribed, while too stingy an offering won't raise the money needed.

7. Preference Share Rights

In a co-op, it is possible to have multiple classes of shares: in a WC, there is typically one class of investment shares for members & some for other investors. Outside investors normally have a preference over member preferred shares.

By the Ontario Act, membership shares may not have any preference, right, or other constraint save a restriction on their issue or transfer. Preference shares are required to have attached to them a preference or right over membership shares.

Here are some rights that can be attached to preference shares:

a. Preference on Dissolution

After payment of all debts, payment of par value and any outstanding dividends before any distribution to holders of membership shares, or members

b. Payment of Dividends

Dividends can be either

i. a fixed percentage of par value – often the case

ii. tied to an outside rate, such as bank prime, or

iii. payable in the discretion of the board of directors

Renewable energy cooperatives, which have no business with members, and new generation co-operatives, which are capital-intensive, will fix the amount of dividends to reflect the financial success of the co-operative in the previous year, instead of paying out surplus generated primarily by way of patronage dividends.

Investors will often be more attracted to a fixed percentage dividend if the right to a dividend is cumulative. As dividends are decided upon by the Board of Directors, it may decide that it is in the best interest of the co-operative to not pay the dividend. In that event, the right to a dividend for that year is extinguished unless it survives to be paid in the future, in priority to future dividend payments. That right is called a right to cumulative dividends

For cooperatives, the cumulative feature can be inhibiting: massive arrears of cumulative dividends make it impossible to attract new capital.

c. Preference for Dividends

The rights to a dividend to be declared and paid in preference to dividends on other shares

d. Redemption

The co-operative may want the right to decide to redeem preference shares without the consent of the preference shareholder. While the co-operative and a shareholder can always agree to a sale of a share back to the co-operative, the right of redemption permits the co-operative to acquire shares by simply tendering the par value, and any accumulated unpaid dividends, to the shareholder.

e. Variable Redemption Price

The co-operative may want the right to redeem preference shares for the payment of less than par value, where the co-operative has suffered a loss. The formula for determining the reduced price to be paid is inserted in the share provisions in the Articles.

In Ontario, the Articles may contain the right to a premium to be paid on the purchase or redemption of shares to reflect the increased value of the co-operative's business. The amount of the premium is calculated according to a formula stated in the articles, and it may not exceed the greater of:

- 10% of the share's par value per annum compounded annually or
- The increase in the Consumer Price Index over the period that the share was outstanding

(This provision has not been used very often.)

f. Retraction

Conversely, the preference shareholder may wish to have the right to require the co-operative to redeem their shares on notice to the co-operative. This right is dangerous in that the retractable preference share will be treated as a liability, and not equity, for accounting purposes, making it harder to obtain bank financing.

g. Partial Redemption

Where only part of the outstanding preference shares are to be redeemed, the shares to be acquired shall be selected, in Ontario,

- By lot,
- In proportion to the number of shares of that class held by each preference shareholder
- As determined by the Board of Directors, provided the selection has been consented to in writing by all the holders of those preference shares or 95% of the holders holding at least 95% of the issued shares of that class, or
- If issued in series, by date of issuance, within the series, from the earliest date to the latest

h. Prescribed Shares

In Ontario, the usual obligation on a co-operative to purchase all the outstanding shares held by a person who ceases to be a co-operative member has an exception for "prescribed shares". The Regulations under the Ontario Act define prescribed shares as "preference shares that provide that the co-operative is not obliged to redeem the shares".

In other words, there is a statutory right of retraction when one ceases to be a member of an Ontario co-operative, unless the shares are prescribed shares. This provides greater assurance that preference shares will be treated as equity for accounting purposes.

i. RRSP-Eligible Shares

Specified co-operative corporations are defined in the Income Tax Act to include co-operatives which market their members' natural products (and process them incidentally to, or in connection with, the marketing of those products), which purchase supplies, equipment or household necessaries for or to be sold to its members or customers or which perform services for its members or customers, hold out the prospect of patronage dividends, permit each member to exercise only one vote, and have, as members at least 90% who are

- individuals

- other co-operative corporations, or
- other corporations or partnerships that carry on the business of farming.

Qualifying shares in such co-operatives are eligible for RRSPs.

What are "qualifying" shares? Ownership of these shares

- can't be required as a condition of membership, and
- patronage dividends can't be paid by the co-operative to the holder of such shares in respect of consumer goods or services.

Lastly, the shareholder of such shares can't be a "connected" shareholder - that is defined, essentially, as someone who owns 10% or more of any class of outstanding shares of the co-operative. This makes it challenging for small co-ops to use RRSPs.

j. Series within a Class

It is cumbersome, when the need for additional capital arises, to call and hold the members' meeting to approve the creation of a new class of shares. Business corporations avoid that by empowering the directors to create a new series of shares within a class, without seeking the approval of shareholders.

In Ontario, the Act was amended in 2004 to allow the Board of Directors of the co-operative to create a series of shares, if the articles authorize them to do so. However, all the shares in any series of a class must have the same priority in respect of dividends and return of capital in the event of dissolution as any other shares in that class.

k. Approval of Changes to Rights

The Ontario Act prohibits any amendment to the Articles to delete or vary a preference attaching to preference shares without the approval of at least two thirds of the votes cast at a meeting of the shareholders.

Brian Iler
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Laird: the summary of crafting investment shares which Brian has laid out is a very good checklist of the kinds of things which people need to bear in mind. One issue is the degree to which the Act tries to anticipate the uncertainties.

The Act may allow issuing investment shares. One thing which the Alberta Act notes, contrary to Ontario, is that investment shares are non-par value shares – so the question is always: how to calculate the share value? It's on a break-up basis. This puts into tension the member rights against investor rights. There are different nuances across the different provinces.

It's a good idea to use Brian's checklist, then look in one's own Act.

BI: share valuation: this is agreed to in business corporations in a shareholders' agreement. But to suggest this in a co-op can be a very daunting expense for co-ops.

LH: so depending on the scale of the arrangement, the Alberta Act also provides for unanimous shareholders' agreements. All of what's available in a business corporation applies in the Alberta legislation. My point is that as the Acts have evolved, they've gotten more into the detail which is quite common. Lawyers tend to pay attention more to business corporations approaches, as that is what they know.

BI: then co-ops tend to become less distinguishable from business corporations. Co-ops can lose their fundamental value – e.g., in the Canada Act & the Alberta act, where the pressure from capital is to provide payments. There can be a reason for investors to vote in an election for directors by reason of a certain event – or a certain percentage of directors. When all the different rights are added up, the tendency of the enterprise shifts to being more like a business corporation. So one has to be careful in a co-op, in crafting the terms and rights.

Discussion:

Q: If you don't have member shares (only member fees), can you issue investor shares? A co-op I'm working with wants to have non-profit status (without member shares), but have investor shares. I can't find a restriction on this.

A-BI: in Ont., you make that decision upon incorporating.
A-LH: Sec. 108 (1) on investment shares addresses this. The Act's must determine if investment shares can be issued to non-members. Can you have a non-profit with shares? Then can you have investments? The issue would really be an income tax issue; could you have an Income Tax exemption? BI: if you are paying dividends not pegged to profits, it should be acceptable. Likely it's possible in Alberta, but not in Ontario.

Q: re: paying dividends:

1) Can a co-op pay dividends if it's in a deficit position on its balance sheet?
   BI: In Ont., one can pay a dividend as long as the co-op isn't (or wouldn't become) insolvent. Likely it would present a problem.
2) For a worker co-op, under the federal Act you're required to distribute 50% of all profits to members as patronage; could this be in conflict with paying to investors?

LH: One could put a limitation in the investment shares – but this would reduce the attraction of the shares.

Q: What about compulsory loans? I had never understood that loans could be compulsory and members could have the option of choosing that.

LH: it depends on the Act and whether it's been made a term of the Articles. If it's not made compulsory in the Articles, then it's a choice.
BI: In Ont., the Act does envision partial share dividends, partial cash dividends, which is the norm. It anticipates dividends being paid in cash or shares, so one could anticipate a member loan in part payment of a dividend.

Q: a patronage dividend based on time worked is equivalent to a bonus, correct?
BI: CRA believes that a patronage dividend in a worker co-op is compensation for employment.

Q: Could a worker bonus be placed into a compulsory loan? A: Likely no. One would have to look at the member agreement and the Employment Standards legislation in the province.

Q: Re: absence of capital gains for investment shares: There are some specific Q's:

1) if a co-op is dissolved, my understanding is that any surplus is paid to members on a pro-rata basis, as a dividend?
   BI: no, this would be distribution of net surplus to members in accordance with the Act, the articles and by-laws.
2) If so, is that eligible for a dividend tax credit?

BI: don't know.

A: Is an increase in par value a capital gain?
BI: yes.
LH: from a tax point of view, we don't know how that top-up amount would be treated.

Q: in order to issue investment shares, are investors seeking voting rights?
LH: it depends whether they're members, under securities legislation. The more traditional investors want every kind of security they can obtain. Depending on the legislation, can you give them these rights? In some Acts, no.
BI: sometimes one does a work-around. A single investor may provide a large amount of capital; one can give them rights to that security but one needs to be comfortable that there are not too many rights attached to investor shares. In Alberta it is possible to have voting rights for investors, but not in Ontario.

BI: It`s possible to have a certain percentage of directors who are investors. One could create a separate class of membership which has such rights.

Q : 1) to clarify: the distinction between classes & series:
Is it that every class has exactly the same rights? One could issue a different series in at different times and they could be redeemed in sequence. Could one have a different series in which each investor would have the same class but a different series of shares? So, the first investor would have first rights of redemption?
BI: Yes. Can have a series selling to only 1 shareholder. They can have different rates of return; this creates series that accommodates itself more to the market. What has to be maintained

across the series: priority in response to dividends, and return on capital in the event of dissolution, equally.
2) What is the scope we need to worry about with security legislation in issuing preferred shares to 10-15 people?

BI: securities are provincially regulated. In Ontario, there is a clear exception for any issue under 35 people, or under $200K, or less than $1,000 /member/ year. But there is no longer an exemption for dealer registration. Q: Does it matter if they live in Ontario? BI: Yes. If talking about more than one province, one needs to be very careful. Some co-ops got multi-jurisdiction exemption. The Lamb Producers Co-op in Saskatchewan & Ontario got a good exemption; as did Growmark. One needs to be careful outside of one's own jurisdiction. If federally incorporated, you have extra provincial registration in the provinces where you carry on business, then you are caught by the provincial legislation. Even if you don't register – you still are caught. Part of the answer is that the exemption for non-profits / those with benevolent purposes seeking to sell bonds, they will be exempt as long as commissions aren't paid, it's structured as a non-profit and has benevolent purposes. This can be used across the country for non-profit coops.

LH: Because we don't have a national security framework, the provincial registers have been willing to accept what has been decided in one province. The issue becomes if you have bad facts you could get a bad results. People should seek especially good examples.

Q: Health co-ops provide services on a non-profit basis. For services under provincial regulation, we cannot charge. For outreach services, we can charge & cover the services well. I am seeking genius ideas for how to raise funds (loans, investments, etc) for services for which we cannot charge due to the Canada Health Act.

BI: as long as the investment is not required to get services, it should be possible to legally seek investments.

Q: the issue is that no one wants to invest. BI: If seeking donations, you need a charitable arm. If seeking capital, one needs to pay a return on it. VH: we do have a charitable arm, & we can use it for community outreach. BI: it should be possible to generate enough from the charges paid by the provinces? VH: the issue is not having a full roster of physicians; linked to not having enough foreign trained physicians certified.

BI the broader issue is whether or not there is a strong financial business.

Q: I hear that it's impossible to design a co-op share which can attract capital gains tax exemption. This puts us on a very unlevel playing field; we have the transaction cost for many small investors. Correct?

BI: subject to the premium in Ontario, that's right.
Comment from questioner: CRA defines this as a deemed dividend, not a capital gain.

LH: we don't know. This is a perfect place to do some research. Accountants are applying the principles from business corporations. This makes co-op capital very hard to market in the outside markets.

Q: in the federal Act, one can set non-par value shares, then set the redemption value based on formula. If one applied the formula, could this be a capital gain? BI: I think it should be a capital gain. LH: CRA has developed the position that a capital gain should be subject to the market, not a choice. I doubt that there is a clear answer.

LH: I have checked into the Federal Act & on the conflict between patronage dividend & retention under the worker co-op provision, so it likely isn't answered.

Hazel thanked all of the participants and the presenters.