

**Legislation for Farmer Co-operatives
in China**

**International Seminar on
Legislation for Farmer Co-operatives
in China
A Canadian Perspective**

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Introduction

THE SEMINAR ON WHICH THIS BOOKLET IS BASED was presented in Beijing, China, 20–21 April 2005 as one of many activities in the Small Farmers Adapting to Global Markets Project, funded by the Canadian International Development Agency and administered by Agriculture and Agri-Food Canada. The purpose of the project is to assist China's small farmers to adapt to new market demands, to improve rural livelihoods, and to meet China's obligations as a member of the World Trade Organization. A subcomponent of the project is to provide training to support the development of farmers' associations in rural China.

Farmers' associations perform several functions but fall into two broad categories. The first includes associations that perform specific economic or commercial functions such as marketing, the supply of inputs, technical and extension services, the provision of credit, access to information, risk management, and so on. The second includes associations that work to promote the general interests of the farm community or a specific segment thereof. Farmers form these associations voluntarily within an enabling legislative and policy regime.

The text below represents the responses of the Canadian team to the issues and questions identified by officials of the Chinese ministries responsible for the development of co-operative law for discussion in the seminar. Dan Ish took the lead in formulating the responses. He and Bill Turner attended the seminar to make the presentation and participate in the proceedings. However, all members of the Canadian team — Murray Fulton, Bernie Sonntag, and Gary Storey — collaborated in the preparation of the final text.

The issues are divided into nine categories with numerous sub-questions and sub-issues within each category. This document responds to eight of the nine categories, although in a somewhat limited manner. The seminar offered the opportunity to provide more detail and specific examples relating to the responses contained herein.

It should be noted that this document is written from the perspective of Canadian co-operative legislation. Examples of legislation provided are from the *Canada Co-operatives Act*¹ passed by the Government of Canada. In addition, each province has its own co-op legislation, which is not subservient to the federal law. Provincial legislation applies to enterprises within provincial jurisdiction, while Canadian legislation applies to those within federal jurisdiction. Each is supreme within its respective realm. There is specific legislation relating to financial co-operatives (credit unions) at both the provincial and federal levels. Nevertheless, most of the legislation is consistent on the fundamental issues addressed in this paper. While legislation is generally not aimed at a particular type of co-op or sector, some provinces have specific legislation relating to New Generation Co-operatives. This has been implemented largely as a response to challenges facing agricultural producers in forming and capitalizing co-operative organizations that are capable of operating up the market supply chain, in making the co-operative's equity more liquid, and in dealing with "free rider" issues. In addition, some co-operatives, such as Saskatchewan Wheat Pool, were incorporated under special legislation.²

1. The Necessity of Legislation for Farmer Co-operatives

THE DESIRABILITY OF ESTABLISHING A LAW TO ALLOW the incorporation of farmer co-operatives can be addressed from both a broad and narrow perspective. From the broader perspec-

tive, producer co-operatives are a form of collective action — they involve a group of producers/farmers coming together to form an organization that in turn provides goods and services to the producer members. They are typically self-governed, with the members of the association providing the leadership for the organization. While day-to-day management of the association is often left with employees, the producer members typically set the policy direction for the association, usually through an elected board of directors.

Co-operative legislation provides the legal framework for collective action to occur. Without the recognition of the collective as a legal entity by the state, a group of individuals associated together for beneficial trading purposes will, for instance, have no legal status in its dealings with third parties. As a result, any contract with a third party must be with an individual member or with individual members of the association. As the complexity of a business increases, this can become incredibly burdensome and a barrier to trading transactions. In addition, without legislation, each group of associated individuals must determine, without the benefit of a legal framework, the nature of their relationship to each other and their governing structure. While this still must be done in the context of associations that are incorporated pursuant to legislation, legislation provides a common fundamental framework within which to make these organizational decisions.

The presence of a legal framework that allows for the establishment of producer associations is important for a number of reasons. First, a formal legal structure provides associations with the ability to enter into contracts and to borrow money, both of which are critical if producer associations are to carry out the functions of trading and providing goods and services to members. These attributes of legal incorporation become increasingly more important as the size (both in terms of amount of business and number of members) increases.

Second, defining the basic organizational features of producer associations in legislation (e.g., the composition of the board of directors, the types of benefit structures that are allowed and not allowed) will ensure that agricultural producers are provided with ownership and control.

Whether the members use these basic organizational features effectively is their decision.

Third, the presence of a legal framework also provides legitimacy to producer associations as *bona fide* organizations. One of the fundamental institutions in an economy and a society is the legal system, which typically reacts to and reflects the changing needs and values of society rather than acting as an architect of these values. Once a plan or policy objective is identified, the legal system assists in putting it into place. Thus, the presence of a legal framework for producer associations is a sign that a country has understood the need for producers to work together to address common problems and is willing to provide them with a mechanism and a structure to assist them.

Fourth, legislation can set out the fundamentals of a co-operative association, many of which distinguish it from a general profit-making company. The legislation can firmly entrench the principle that the members of the co-operative ultimately are the ones who control it. Without legislation this fundamental characteristic may be absent or ambiguous.

Fifth, legislation granting legal status to a co-operative association generally provides limited liability to the members, meaning that members are not liable for the debts of the organization. Rather, members are liable to pay only the full amount of the value of their shares or membership. Any debts of the co-operative cannot be collected from the members in the absence of a guaranty of those debts by individual members. In contrast, individuals engaging in collective commercial action run the risk that each person will be liable for all the debts of the association.

There are a number of reasons why farmers may find it desirable to form collective organizations (farmer associations), including the ability to address a lack of market power or a lack of market information, and to provide goods and services more efficiently than government can provide them. Farmer associations can often develop new agricultural technologies and assist with their extension. They may be able to provide credit to rural areas efficiently, thus supporting rural socio-economic development.³

2. The Corporate Capacity of Farmer Co-operatives

IN CANADA, AND MOST OTHER WESTERN COUNTRIES, virtually all co-operatives are incorporated pursuant to specific co-operative legislation and thus have legal status (i.e., legal capacity like a natural person). Only legally incorporated co-operatives are allowed, by law, to use the name “co-operative,” or any derivative thereof, in their trading name. Because the nature of co-operatives is well known in the economy, there is little confusion among co-operatives, investor-owned firms (ordinary business corporations), and not-for-profit corporations.

The lack of confusion among the various types of enterprises is attributable to the fact that co-operative legislation carefully prescribes the characteristics that must be present before an organization can be incorporated and thus legally recognized as a co-operative. The *Canada Co-operatives Act* only allows incorporation of associations that are organized on a “co-operative basis,” which is defined in the *Act* by commonly accepted co-operative principles, one of the most notable being that each member has only one vote in the governance of the association. Any organization that uses the word “co-operative” in its name is generally known to have unique characteristics that clearly distinguish it from general profit-making and nonprofit companies. This can likely be achieved in China if co-operative legislation is cast narrowly enough to be available only to associations that adopt clearly stated co-operative principles.

3. Co-operative Membership

PERHAPS THE MOST FUNDAMENTAL CHARACTERISTIC of western co-operatives is that the members of the association must be those who use its services. History tells us that the strength of co-operative enterprises flows from the common interest of the members; in the case of farmer/producer co-operatives, it is the provision of goods and services that binds the members to a common collective action. Canadian legislation generally restricts membership “to persons who can use the services of the co-operative” (see ss. 7(1) of the *Canada Co-operatives Act*). It is important to note that while other forms of participation in a co-operative may be permitted, subject to some exceptions, it is only the members who can exercise a vote and membership is only open to users of the co-operative.

In Canada, membership in a co-operative is open to individuals, other co-operatives, or other non-co-operative entities (profit-making enterprises) so long as they have legal status. The rights of all entities are the same, as is entitlement to membership. For instance, the principle of one member, one vote applies to all, and membership is open only to those who can utilize the services of the co-operative. The problem of differentiating the marketing and operational businesses of members from those of the co-operative association is usually dealt with in the by-laws of the association, which typically require that members must not engage in business activities that compete with the activities of the co-op. The by-laws have a contractual binding effect on all the members.

Generally, in Canada, all membership shares are equal in terms of voting — one member, one vote. Where co-operatives have investment shares, in addition to membership shares, the investment shares do not carry voting rights. If voting and distribution of surpluses/profits are

weighted according to investment, then the association would not be incorporated as a co-operative. Rather, it is likely that incorporation would be sought under the *Business Corporations Act*.

4. The Financing of Co-operatives

CANADIAN CO-OP LEGISLATION DOES NOT REQUIRE co-operatives to obtain a minimum amount of capital from members, either paid-up capital in the form of share purchases or loans. These decisions are left to the discretion of the co-operative itself.

Co-operative financing can generally be categorized as internal or external. Internal financing includes price paid for shares, member loans, undistributed income of the association, and retained patronage dividends. External financing includes price paid for investment shares and loans from external agencies such as banks or governments.

Co-operatives may require that members purchase a set number of shares rather than a minimum of one share per member. The primary reason would be to acquire an appreciable amount of capital.

Retained earnings form an important source of finance for co-operatives that operate with a surplus/profit. The retained earnings serve as a source of investment capital, which might be expensive and limited if sought from external sources, as well as a reserve against unforeseen losses. This can be done because it is within the discretion of the board of directors whether to pay out surpluses as patronage dividends or retain them for use by the association.

One factor that militates against the retention of earnings in Canadian co-operatives is that retained earnings are taxed in the hands of the co-operative under the *Income Tax Act*. Patronage dividends are deductible from income so long as they are credited to the member/patrons, even though they are in fact retained by the co-operative. Retained

earnings not credited to members, however, are not deductible. This income tax implication often leads co-operatives to credit patronage dividends to members but not actually pay out the dividends; the association uses the funds. These retained patronage dividends are sometimes pejoratively referred to as “forced loans.”

The ability to allocate but not actually pay patronage dividends is provided for in the legislation, which enables a co-operative to raise capital by means of a revolving loan fund. Annual patronage dividends are credited to members but are regularly retained by the co-operative as compulsory loans until the desired fund has been accumulated by the co-operative. Future patronage dividends continue to be withheld by the co-operative either in whole or in part, and earlier loans are retired in chronological order. The result is that the members receive by way of a patronage dividend from the co-operative, an amount, retained by the co-operative in an earlier year under the compulsory loan by-law, which has been retired. The retirement of such loans, similar to a declaration of a dividend, is a matter for the discretion of the directors, unless specific provisions exist in the by-laws.

Canadian co-operatives can now issue investment shares to non-members. The significant distinction between membership shares and investment shares is that the latter carry no general voting rights, although the owners of the shares are eligible to be on the board of directors, subject to limitation on the number of nonmember directors, and to vote for those directors.

Most Canadian co-operatives do not issue investment shares. An exception is the Saskatchewan Wheat Pool, a co-operative in business since the 1920s, which issued investment shares in March 1996 that traded on a public stock exchange. In March 2005 the Saskatchewan Wheat Pool ceased being a farmer-owned co-operative. Many people argue that the seeds for the disintegration of the Pool as a co-operative were sown when it decided to obtain capital from external sources through investment shares rather than operating as a traditional co-operative, which issues shares only to its user/members.

The precise procedures for redeeming member shares, or investment

shares, can be determined by the co-operative itself in its by-laws. If membership shares are par-value shares, the redemption is at par value. If the shares are no-par-value shares, then the price of redemption is in accordance with a formula set out in the articles. If there is no price or formula set out in the articles, then the redemption must be at a fair price. Investment shares are redeemed pursuant to a formula similar to non-par-value shares.

5. Co-operative Favourable Balance (Profit) Distribution

THE CONSTRAINTS WITH RESPECT TO A CO-OPERATIVE paying dividends relate primarily to its ability to meet its liabilities. For instance, the *Canada Co-operative Act* restricts the payment of a dividend where there are reasonable grounds to believe that:

- (a) the co-operative is, or would after the payment be, unable to pay its liabilities as they become due; or
- (b) the realizable value of the co-operative's assets after payment of the dividend would be less than the total of its liabilities and the stated capital of all its issued shares. (s. 154)

The "stated capital account" is the total amount received, in cash or kind, for the issued shares.

The surplus/profits of a co-operative are distributed to members on the basis of the amount of business they do with the co-operative. Patronage dividends may also be paid to nonmembers who do business with the co-operative. Any liabilities owed to creditors, or amounts owed to investment shareholders pursuant to the terms of the investment shares, are accounted for prior to determining the surplus from which patronage dividends are paid.

The surplus/profits of a co-operative usually arise as a result of the

business it does with members based on the going market price for the good or service provided or the product being traded. At the end of an accounting period, the surplus is determined after taking into account the co-op's operating costs for the period in question. If there are positive earnings (a surplus or profit), this amount may be distributed on the basis of patronage. It is important to recognize, however, that it is within the discretion of the directors whether or not to pay a dividend rather than retaining the surplus as capital for the co-operative.

Legislation does not generally require co-operatives to set aside a fixed percentage of their net surplus (a reserve) before patronage dividends are paid, but rather, allows the co-op to make provision for reserve requirements in the by-laws. Thus, rather than imposing reserve requirements upon co-operatives, the state leaves the decision to the members of the association itself. The exception is financial co-operatives (credit unions), where the state imposes strict reserve requirements because they are deposit-taking institutions.

Any grants or financial support from the Government in Canada would be subject to the terms and conditions of the grant itself. If a grant is unconditional with respect to repayment, it may very well contribute to a co-operative being profitable, and these profits would enable the co-op to pay a patronage dividend.

A co-operative may provide in its articles of incorporation for the manner of the distribution of assets upon dissolution. Subject to the payment of creditors, a co-operative has considerable latitude in determining the rights upon dissolution. For instance, the property could be divided equally, upon the basis of patronage or even upon the basis of invested capital. Failure to make provision for the distribution of property may result in the property of the co-operative devolving to the state.

6. The Co-operative Accounting System

CANADIAN CO-OPERATIVE LEGISLATION REQUIRES THAT an audited financial statement be provided to the members at each annual general meeting. The financial statement must be prepared by an auditor who is “independent of the co-operative, of any of its affiliates or of the directors or officers of the co-operative or its affiliates” (*Canada Co-operatives Act*, ss. 253(1)). This is to ensure that members, shareholders, investors, and creditors (present and future) receive objective financial information from someone who does not have an interest in the co-operative.

The legislation does not contain specific provisions designed to control the accounting methods used by co-operative associations. The government regulations promulgated pursuant to the legislation do require, however, that financial statements and auditor statements “shall be prepared in accordance with the generally accepted accounting principles set out in the handbook of the Canadian Institute of Chartered Accounts.” Thus, while the legislation does not require an accounting system specific to co-operatives, “generally accepted accounting principles” have been developed to deal with the uniqueness of co-operative businesses. The unique aspect relates primarily to developing accounting systems to deal with patronage dividends. In most respects, accounting systems for co-operatives and general profit-making companies are similar.

7. The Relationship between Government and Farmer Co-operatives

GOVERNMENT USED TO PLAY A MAJOR ROLE IN THE regulation of co-operatives in Canada, with administrators scrutinizing their activities to ensure that they were complying with legislative requirements. A significant shift in ideology in the 1970s was reflected in amended legislation, which moved from being “regulatory” to being “enabling.” If a co-op meets the basic requirements of the legislation, it is entitled to receive a certificate of incorporation, and the ongoing supervision of its activities is reserved for “interested persons,” primarily members, shareholders, and creditors.

A government official, variously known as the “director” or “registrar,” will review an application for incorporation to determine if the fundamental requirements of the legislation have been met. The official must be satisfied that the applicants are qualified, that articles of association are filed, that the proposed name is appropriate, and that the association will be carried on “on a co-operative basis.” Numerous other requirements exist as well, such as listing the location of head office. If all the conditions are met, the official must issue a certificate of incorporation; unlike the situation that existed prior to the 1970s, there is no residual authority to deny incorporation.

Once a co-operative is up and running, its supervision is relegated largely to its members, investors, and creditors — collectively called “interested parties.” If an interested party, which also includes the director or registrar, believes the activities of the co-operative are being conducted improperly, he or she can make an application to a court to have the situation rectified. If satisfied that grounds exist, a court may appoint an investigator and make appropriate orders. Examples of activities that

may give rise to a court application include an allegation that an association is not being conducted on a “co-operative basis,” that directors are acting beyond their authority, or that a group of members or shareholders is being dealt with unfairly and prejudicially.

8. National Policies Supporting Farmer Co-operative Economic Organizations

CANADIAN CO-OPERATIVES ARE INCORPORATED under either federal or provincial legislation. In fact, most co-operatives are provincially incorporated and the majority of support comes from provincial governments, most commonly by the provision of personnel to assist with co-op development, rather than in the form of monetary grants. These external agents lend their expertise to the formation of an organization but are not directly associated with it (for instance as a member). At the most basic level, this form of governmental assistance helps to offset many organizational problems, such as organizing meetings, getting agreement on the idea of forming an association, and deciding on the association’s activities.

Once a common purpose is defined, these agents also identify appropriate leaders for the group, assist in the identification of potential members, locate resources for business plans and industry analyses, and help to ensure that the association proceeds only if the outlook is reasonably favourable.

Government personnel who assist with co-operative development can provide invaluable assistance because of their expertise and their objective point of view. An important role is to build trust and co-operation among the members of an association in an incremental and sequential manner. Rather than occurring within a single step, the process of forming associations often involves a series of small steps — with low initial costs — that progressively build upon one another.

It is interesting that the role of external facilitative agents has been provided not only by governments, but also by universities, other more established co-operatives, and local business and religious leaders.

In some instances, both federal and provincial governments have provided small amounts of financial assistance to help farmer groups access professional services to develop business plans and to incorporate a co-operative. The Canadian government has recently undertaken a five-year program to provide “seed” money for the development of innovative co-operative approaches that deal with federal policy priorities, one of which is agricultural diversification and adding value to agriculture. This initiative is governed by a steering committee appointed by the minister.

The co-op sector in Canada partners with universities and government to provide teaching, research, and extension on co-operatives. The Centre for the Study of Co-operatives at the University of Saskatchewan, for example, is funded by a partnership arrangement between the co-op sector and the university, with modest financial support from the provincial government. Similar funding arrangements exist at universities in other Canadian provinces.

Various governments support co-operative development by assigning responsibility for co-operatives to a particular ministry. A small staff advises the minister on co-operative issues, liaises with the co-op sector, conducts or contracts for research on co-operatives, and gathers co-op statistics. Governments often appoint an advisory group from among co-operative leaders and academics to provide advice to the minister.

At the provincial level, Québec likely has one of the most supportive policy environments for co-operatives. For example, the province has established Regional Development Co-operatives to encourage socio-economic development in both rural and urban areas, and has also adopted tax policies that encourage members to invest in their co-operatives.

Most direct government financial assistance in Canada has not been aimed at co-operatives *per se* but at activities in which co-operatives are engaged. For instance, both national and provincial governments have directed funds towards housing co-operatives not solely because they are

co-operatives but because they provide housing to people of modest means. They also grant funds to health co-operatives because they provide health services.

Conclusion

PERHAPS THE MOST SALIENT FEATURE OF CANADIAN co-op legislation is the commitment to member control of co-operative associations, which is manifested in many ways, most notably in the principle of one member, one vote. Numerous other provisions in the legislation help ensure that control ultimately resides with the membership. Aside from the legislative provisions that reflect international co-operative principles as articulated by the International Co-operative Alliance, Canadian co-operative legislation is similar in many respects to that which controls general profit-making companies.

Endnotes

- 1 See www.parl.gc.ca/36/1/parlbus/chambus/house/bills/government/C-5/C-5_4/body4E.html
- 2 Although it functioned as a co-operative organization for more than eighty years, beginning in the 1920s, Saskatchewan Wheat Pool ceased to be a co-op in 2005.
- 3 For more details on the reasons for farmer associations, see Murray Fulton, "Producer Associations: The International Experience," in *China's Agricultural and Rural Development in the Early 21st Century*, edited by Bernard H. Sonntag, Jikun Huang, Scott Rozelle, and John H. Skerritt (Canberra: Australian Centre for International Agricultural Research, 2005.)