



## MINISTRY OF AGRICULTURE, FOOD AND RURAL AFFAIRS

## How to Form a Cooperative

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### Introduction

Co-operatives have existed in Ontario for more than 150 years. Co-operatives have been formed to meet the needs of various business sectors and communities in rural Ontario. The co-operative business structure is only one of a number of structures that businesses can use.

This factsheet is designed to help business owners and rural communities understand the co-operative structure and determine if it is a suitable structure for their situation.

New generation co-operatives are a variation on the traditional co-op structure. They have been successfully used in a variety of situations, most notably where agricultural producers wish to gain ownership in value-added and further processing activities.

### Section 1. The Basics of Co-Operatives

#### What is a Co-Op?

A co-operative is a business organization owned by the members who use the services of the co-operative. Control rests equally with all members and surplus earnings are shared by members in proportion to the degree they use the services.

#### Basic Principles of a Co-Operative

All co-operatives are guided by the same general principles as stated by the International Co-operative Alliance. These principles are:

**Voluntary and open membership** - Co-operatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership.

**Democratic member control** - Co-operatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions.

**Member economic participation** - Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative.

**Autonomy and independence** - Co-operatives are autonomous organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

**Education, training and information** - Co-operatives provide education and training for their members, elected representatives, managers and employees so they can contribute effectively to the development of their co-operatives.

**Co-operation among co-operatives** - Co-operatives serve their members most effectively, and strengthen the co-operative movement, by working together through local, national, regional, and international structures.

**Concern for community** - Co-operatives work for the sustainable development of their communities through policies approved by their members.

### **Types of Co-Operatives**

Co-ops exist in almost every sector of the economy. See the various types of co-operatives listed below:

#### **Profit Versus Non-Profit Co-Operatives**

Co-operatives can be formed as either for profit or not for profit co-operatives. In both cases the goal of the co-operative is to operate profitably, however, the surplus revenues are handled differently in these two types of co-operatives.

- For-profit co-operatives: Surpluses of the enterprise, after payment of dividends on shares and interest on loans, are distributed at the discretion of the directors among the members in proportion to their business transactions with the co-operative during the fiscal year.
- Not-for-profit co-operatives: Operating surpluses of the enterprise are not distributed to the members and must be returned to the co-operative's general reserve. The co-op can use these funds to improve services to members, distribute them to other non-profit co-operatives or give them to charity.

#### **Producer Co-Operatives**

- Some co-operatives process and/or market, their members' products and services directly.
- Others may also sell the input necessary to their members' economic activities (such as agricultural supply co-operatives).
- Owned by members who either purchase their inputs or supply the products and services they market.
- Examples: Agricultural processing and marketing, farm supply, crafts, livestock and crops, seed cleaning, pooling of equipment.

#### **Service Co-Operatives**

- They provide services to their members (individuals or corporations).
- They are owned by the users of the services.
- They can range in size from small daycare centres to large housing co-operatives.
- Examples: Community development, electricity, natural gas housing, daycare centres and nurseries, health care, transportation and communication, tourism.

#### **Financial Co-Operatives**

- These co-operatives offer financial, loan or investment services, and insurance services to their members.
- They are owned by user members or by subscribers to insurance.
- Examples: Caisses populaires, credit unions, insurance co-operatives, mutual companies.

#### **Multi-Stakeholder Co-Operatives**

- The membership of these co-operatives is made of different categories of members who share a common interest in the organization (e.g., clients, workers, investors, community organizations, etc.).
- Examples: Home care services, health services, community services.

#### **Consumer Co-Operatives**

- They provide their members with goods for their personal use.

- They are owned by the consumers of the goods sold by the co-operative.
- Examples: Food, natural food, school supplies (stationery, school supplies, computers and software), hardware, clothing.

### **Worker Co-Operatives**

- The purpose of these co-operatives is to provide their members with work by operating an enterprise. They may be found in all economic sectors.
- These co-operatives are owned by their employee members. They are mainly part of the small or medium sized enterprise sector.
- Examples: Agri-food, natural food, manufacture and sale of clothing, communications and marketing, industrial production and manufacturing, home nursing services.

### **Organizational Structure**

A co-operative has three key groups of people:

#### **Members**

Members, as owner-users, are the reason the co-op is organized. They justify its continued existence through their patronage, capital investment and participation in decision-making. The members are represented in the co-op by the Board of Directors.

#### **The Board of Directors**

The Board of Directors is a policy-making body, elected by the members, that represents the members by overseeing the co-op's business affairs. Usually seven to nine members (minimum three) are elected to provide leadership. Directors, as trustees, establish policy, report to members and give direction to the co-op's hired management, generally without getting involved with the day-to-day operations.

Members of the board are held accountable for their actions by provincial and federal laws applying to businesses and by the by-laws of their co-op. For larger co-ops the Board of Directors also retains an independent auditor to evaluate the co-op's financial condition. They may also appoint committees for such continuing concerns as property, finance or member relations, education or appoint ad hoc committees for fundraising or special projects. The board is directly responsible for hiring the manager but delegates the responsibility for choosing co-op staff to the management.

#### **Management**

Management supervises and co-ordinates the day-to-day operations of the co-op and are supervised by the Board of Directors.

### **Comparison of the Co-Operative and Corporate Business Structure**

Listed below is a comparison of the features of the for-profit and not for profit co-operative and corporation business structures.

#### **Co-Operatives - For-Profit**

**Purpose:** Service and saving for members.

**Ownership:** By members.

- The share is listed in the member's name.
- Unless otherwise stated in the articles, co-op shares may not increase in value and may only be redeemed by the co-operative at their par value.

**Control (Voting):** One member, one vote, no proxy voting.

- A member is entitled to only one vote at a general meeting, regardless of the number of shares he or she holds.
- Certain co-operatives with a large and dispersed membership may introduce delegate structure for representing members (e.g., delegates representing multiple members from a geographic district).

**Liability:** Members limited to share subscription.

- Directors can be liable.

**Distribution of Surplus or Earnings:** To members in proportion to use of service.

- Allocated, but members may choose to reinvest.
- Surpluses may be paid into the reserve or to members in the form of patronage returns proportional to the business done by each member with the co-operative or as dividends.
- Dividends on membership shares are limited to a maximum of 2% above prime; preference shares have no maximum.
- Premiums paid on the redemption of preference shares have a maximum of 10% compounded per year.

**Initiation of Policies:** Board of Directors, members and management.

### **Co-Operatives - Non-Profit**

**Purpose:** For social, cultural and economic needs of members.

**Ownership:** By members.

- Same as for-profit

**Control (Voting):** One member, one vote, no proxy voting.

- Same as for-profit.

**Liability:** Members limited to membership amount.

- Directors can be liable

**Distribution of Surplus or Earnings:** Surplus remains in co-op.

- Surplus goes to another non-profit group at time of dissolution.

**Initiation of Policies:** Board of Directors, members and management.

### **Corporations and Investor Owned Business - For-Profit Corporation**

**Purpose:** Profit for shareholders on investment of time or money.

**Ownership:** By shareholders.

- Generally, a share carries no name.
- Unless registered, it belongs to the bearer.
- A common share may increase in value. A shareholder may sell his or her shares to another person at an agreed upon price.
- Some classes of shares can have additional rights.

**Control (Voting):** The number of voting shares held per shareholder.

- The number of votes a shareholder is entitled to at a general meeting is equivalent to the number of shares held in the company.
- A shareholder may obtain a proxy to vote for other shareholders.

**Liability:** Shareholders limited to share subscription.

- Directors can be liable.

**Distribution of Surplus or Earnings:** Dividends paid on shares.

- Rate set by Board of Directors.
- There is no limit on share dividend.
- Profits may be distributed in the form of dividends according to the provisions for each class of shares, or reinvested in the company.
- The value of shares reflect the net value of the corporation.
- Shareholders may dispose of all of the assets of the business in accordance with certain legislative provisions.

**Initiation of Policies:** Board of Directors, shareholders and management.

### **Corporations and Investor Owned Business - Non-Profit Corporation**

**Purpose:** Social and cultural activities other than personal financial gain.

**Ownership:** By members.

- There is no ownership.
- Members are accepted when they agree to pay annual dues conferring member status, or a one-time membership fee.
- As the by-laws permit, anyone may become a member, whether or not they use or benefit from the services provided by the organization, as long as they support the purpose of the organization.

**Control (Voting):** One member, one vote unless otherwise specified in the articles or by-laws.

- Delegates or proxies may be used depending on the governing legislation.

**Liability:** Limited to the investment.

- Directors can be liable.

**Distribution of Surplus or Earnings:** Surplus remains in corporation.

- Surplus goes to the membership or to another charitable organization at time of dissolution.
- Surpluses do not belong to individual members but to the organization.
- They may, therefore, not be redistributed among the members but must be returned in full to the indivisible general reserve of the organization.

**Initiation of Policies:** Board of Directors, members and management.

### **Staff of the Co-Operative**

Staff of the co-operative report to management. They should be well informed about co-operative's activities and able to explain them to both members and non-members.

## **Section 2. Forming a Co-operative**

The process of forming a co-op is not very different from that of any other form of business venture. There is the planning process and the technical details of setting up the structure. The development of a fully operating business from an initial idea requires strong organizational and communication skills and a comprehensive business plan. See [Appendix 1](#) for a complete checklist of the planning process.

The following steps outline the order of events that are typical in the formation of a co-operative.

**Initial idea and key organizers** - An idea for the co-op is usually formed by a key group of individuals who see a business opportunity or a solution to a problem.

**Select a steering committee** - Select a steering committee from the initial group and from those willing to fund the feasibility study.

**Conduct a feasibility study** - Plan the scope of a feasibility study, including areas of study and the amount of budget required. Evaluate the feasibility of the business idea carefully before proceeding. Funding for the feasibility study can be raised by the organizers and potential members or possibly through an economic development agency.

Such a study not only determines the economic viability of the venture but also outlines the market advantages of a member owned co-operative, if any. If the feasibility study is positive, this builds enthusiasm among the steering committee for the project and the organizers can proceed to the next step.

**Select an interim board** - If the feasibility study is positive and the decision is made to proceed with forming a co-operative, dissolve the steering committee and set up an interim board. Elect a chairman and explore funding sources to complete the business plan. The interim board can decide if it is appropriate to recruit a chief executive officer.

**Incorporate the co-operative** - The timing of incorporation depends on a number of factors including the need to enter into legal agreements such as confidentiality agreements, letters of intent, supply agreements or funding agreements with governments. Incorporate as soon as there is potential exposure to liability.

Develop the business plan and the legal organization of the co-operative - The business plan outlines the goals and objectives of the co-operative and the steps to reach those goals. The board uses this information, along with the business plan, to promote the co-operative and provides a basis for filing an offering statement with the Financial Services Commission of Ontario, where required. (See [Financing the Co-operative.](#)) This must be done before the sale of shares can take place. For details about what to include in a business plan see [Appendix 2.](#)

Information on feasibility and preparing business plans is available from OMAFRA, local Business Enterprise Centres and private consultants.

A key element in forming a co-operative is the involvement of potential co-op members. This ensures a variety of input to the plan and encourages members to develop ownership and commitment to the co-op.

**Prepare an offering statement** - Co-operatives wishing to raise more than \$200,000, issue shares to more than 25 members or issue shares with a value of more than \$1,000 per member are generally required to file an offering statement (similar to a prospectus) with the Financial Services Commission of Ontario (FSCO).

**Conduct a fundraising campaign** - Once the legal and filing requirements are in place and the business plan is finished, the board can launch a funding campaign.

### **Incorporating the Co-Operative**

The following information regarding the *Co-operative Corporations Act, 1990* and the legal structure of a co-operative is general information and should not replace competent legal advice.

The *Co-operative Corporations Act, 1990* is administered by the Financial Services Commission of Ontario.

A co-operative requires at least five persons to incorporate. The exception to this is worker co-operatives that require only three people. These incorporators may be individuals, who are at least 18 years old, or they can be corporations, including other co-operatives.

The following is a summary of some of the more important requirements of the act; however, it should not be used in place of the act. A schedule of fees for incorporation is available from the Financial Services Commission of Ontario.

The act requires that a co-op corporation must carry on an enterprise that is organized, operated and administered under the following principles:

**Each member or delegate has only one vote:** In a business corporation, the number of votes a shareholder has depends on the number of shares owned in the company. In a co-op corporation, each member has only one vote regardless of the amount invested in the co-op.

**No member or delegate may vote by proxy:** This serves as a check against the accumulation of power by one or more members.

Interest on loan capital and dividends on share capital are limited: Interest on member loan capital and dividends on share capital are limited to a cap of prime rate plus 2% as fixed by the *Co-operative Corporations Act, 1990*. An exception is made for preferred shares in that the dividend rate has no limit and can be determined by the co-operative.

## Articles of Incorporation

- To incorporate a co-op in Ontario, you must file Articles of Incorporation with the Financial Services Commission of Ontario (FSCO). The Articles of Incorporation, along with the *Co-operative Corporations Act, 1990*, provide the basic legal framework for your co-op. They outline its purpose and how it will be financed. They can be seen as the "constitution" of your co-operative. The Articles of Incorporation include:
  - the name and location of the co-operative
  - names, addresses and signatures of the incorporators
  - the number of directors of the co-operative
  - how the co-op finances itself - by accepting loans, selling debentures or charging membership fees
  - the share structure of the co-operative
  - any special restrictions or provisions which apply to the co-operative

## Choosing a Name

A co-op's legal name must contain the word Co-operative (or Co-op) and must end with either the word corporation or incorporated. Co-op corporations that have share capital may also choose to use the term limited. It is illegal in Ontario to use the word co-operative in connection with the name of an enterprise unless the group is incorporated under the *Co-operative Corporations Act, 1990*.

Once the proposed name has been chosen, hire a private search house to ensure no other group is using the same name. The search house will supply a Newly Updated Automated Name Search (NUANS) that you submit to the Ministry of Finance. A list of the private search houses in Ontario is available from the Ministry of Finance.

## Filing for Incorporation

To incorporate a co-operative you need to send the following documents to the FSCO:

- proof of a NUANS report
- a cheque or money order for \$15 to reserve the name chosen. (This is in addition to the incorporation fee noted below.)
- Articles of Incorporation (2 original copies) - distinct forms for co-operatives with share capital (Form 1) and co-operatives without share capital (Form 2)
- consent to act as first directors (if your co-operative has directors who are not incorporators)
- a cheque or money order for \$155 to incorporate a non-profit co-operative, or \$335 for other co-operatives

You may wish to send a draft version of your Articles of Incorporation to FSCO for an opinion. Obtain the forms required from FSCO. When this process is complete, FSCO will issue a Certificate of Incorporation, which shows your co-operative is legally incorporated.

Once you receive your Certificate of Incorporation, you have 60 days to register your co-operative with the Ministry of Government and Consumer Services by filing an Initial Notice form. This form includes basic information about your co-operative, including its name, date of incorporation, the address of its head office

and the names and addresses of its directors and officers. The form is available online ([ontario.ca/forms](http://ontario.ca/forms)) from the Ministry of Government and Consumer Services; form number 007-07200.

Obtain co-operative incorporation information from:

Financial Services Commission of Ontario

P.O. Box 85

5160 Yonge Street

Toronto, Ontario

M2N 6L9

Telephone: 1-800-668-0128

Website: [www.fSCO.gov.on.ca](http://www.fSCO.gov.on.ca) <<http://www.fSCO.gov.on.ca>>

To change your Articles of Incorporation you must file Articles of Amendment with FSCO. A fee is charged each time these documents are filed.

By comparison, changing the by-laws of your co-op is simpler and does not require you to file documents with FSCO or pay a fee. In order to avoid filing Articles of Amendment with FSCO, include most of the basic rules of your co-operative in its by-laws, rather than in its articles. These rules would include, for example, how elections work and how members must deal with the co-op.

Contact a co-operatives association such as the Canadian Co-operative Association (CCA) or The Ontario Co-operative Association for advice on what to include in your by-laws.

### **Federal Incorporation**

If the co-operative is going to do business outside Ontario, consider incorporating federally. To incorporate under federal legislation, the co-op must be conducting business in two or more provinces and have a fixed place of business in more than one province. Under the federal *Co-operatives Act*, at least three persons, of age 18 or older, are required to incorporate a cooperative. It is important to note that co-operatives incorporated outside of Ontario jurisdictions are subject to the Ontario Securities Commission (OSC). This means they will be required to meet the regulations and securities legislation administered by the OSC.

Information about federal incorporation can be obtained through Innovation, Science and Economic Development Canada at [www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h\\_cs03926.html](http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h_cs03926.html) <[http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h\\_cs03926.html](http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h_cs03926.html)>

### **Preparing By-Laws**

The next step is to elect officers and enact by-laws. By-laws explain how the co-operative will operate and expand on the Articles of Incorporation. By-laws do not need to be filed with FSCO. By-laws take effect once approved by the Board of Directors and ratified by the members. All by-laws must comply with the provisions of the act.

Some of the topics to covered in the by-laws are:

- membership and divisions of membership
- requirements for membership and rights and responsibilities of members
- requirements for supply agreements
- member loans or share capital; share or loan certificates
- meetings of members
- Board of Directors and officers - number, duties, terms of office and compensation
- election of delegates
- use and distribution of surplus funds
- borrowing powers; cheques, drafts and notes
- bonding of employees and officers
- custody of securities
- execution of documents

- fiscal year
- notices, amendments

Have the articles and by-laws prepared by professionals familiar with co-operative law and practice. Ensure directors are involved in the process and that they understand how the articles and by-laws affect the co-op.

### **Financing the Co-Operative**

Co-operatives can raise capital through equity or debt financing. Co-operatives can choose to incorporate either "with share capital" or "without share capital". Incorporating "with share capital" allows a co-operative to raise capital by selling shares as well as using debt instruments such as debentures. A co-operative that incorporates "without share capital" can only raise capital through debt financing and may not issue shares. A co-operative must decide how they will file before the incorporation process begins.

The business plan for the co-operative states how much capital the co-op will require and for what purpose. Additional capital may be raised through preferred share offerings, member loans and other securities. If the co-op is not successful this investment may be lost.

### **Offering Statements and Exemptions from Filing**

Before a co-operative can issue either shares or debentures it must determine if it is required to file an offering statement with FSCO. The purpose of the offering statement is to provide potential investors with a full, true and plain disclosure of all material aspects of the co-operative's operations and proposed business. This includes both the current state of the business and the intended use of the money being raised. The offering statement allows a potential member to assess the risk associated with investing in the co-op.

A co-operative does not have to file an offering statement if there are:

- thirty-five or fewer security holders
- more than thirty-five security holders but the shares or debt obligations issued to members does not exceed \$1,000 per member in a year and does not exceed an aggregate value of \$10,000 per member or the aggregate value of all securities issued does not exceed \$200,000

Standard forms and sample templates for the offering statement are available from the Financial Services Commission's website at [www.fSCO.gov.on.ca](http://www.fSCO.gov.on.ca) <<http://www.fSCO.gov.on.ca>> . Offering statements are legal documents and can be complex. Advice from a professional with specific experience preparing such documents should be sought.

### **Equity Financing - Incorporating With Share Capital**

If a co-op will require a large amount of capital for equipment, supplies, facilities, etc., it would likely benefit from share capital incorporation. When incorporating with share capital, patrons must buy membership (common) shares in the co-op as a requirement of membership. This is an investment in the co-op. If the co-op is not successful, the investment may be lost. Share capital incorporation allows greater financing flexibility because a share capital co-op can use debt financing as well as equity financing. Non-share capital co-ops, however, must incorporate without share capital.

### **Types of Shares**

There are two basic types of shares, membership shares and preference shares.

Both types of shares are par value shares. This means that when your co-op redeems or buys back its shares from members or other investors, the amount they receive for each share is equal to the amount they paid for the share. To help protect investors against inflation, your co-op may choose to pay an extra amount or premium for preference shares they redeem. The maximum premium for a preferred share is 10% per year compounded or the Consumer Price index, whichever is greater. Paying a premium will help ensure that the value of your co-op's shares keeps pace with inflation. Paying premiums also means that your co-op will have less equity, so striking a balance is important.

Your co-op may pay investors a return on its membership and preference shares. This return is called a dividend. The maximum dividend any co-op may pay on membership shares is capped at 2% above the prime rate of any financial institution (credit union, bank, trust company) named in the co-op's by-laws.

There is no cap on the dividend that may be paid on preference shares unless your co-op chooses to have one.

### **Membership Shares**

If all the equity your co-op needs can be raised from members alone, it might be enough for your co-op to issue only membership shares. In this case the co-op would require members to buy a minimum number of membership shares as a condition of membership.

Co-ops that issue shares must issue membership shares. Membership shares may be held only by members. Because of this, co-ops restrict how members may transfer ownership of their membership shares. If a co-op does allow transfer of membership shares, the approval of the Board of Directors is required. This feature of membership shares may affect how attractive they are to member investors.

### **Preference Shares**

Your co-op might also consider issuing preference shares if there are members or other community investors willing to invest. Preference shares may be held by members or other investors and may be more attractive because:

- Co-ops generally require dividends to be paid on preference shares before they are paid on membership shares. Co-ops that offer an attractive dividend on their preference shares and establish a record of paying this dividend will find it easier to attract investment in the future.
- When a co-op is dissolved, preference shareholders generally rank ahead of holders of membership shares in their claim on the co-op's assets but behind creditors and debenture holders.

### **Other Ways to Raise Equity**

Your co-op can also require members to use some or all of their patronage returns to buy more shares. By doing so, your co-op can ensure that its equity grows each year, provided of course that your co-op has earned enough to pay patronage returns in the first place.

Another way for your co-op to use its own earnings to increase its equity is to pay out dividends in the form of shares rather than cash. Dividends paid out in the form of shares are called stock dividends. Stock dividends allow your co-op to pay dividends and add to its equity capital at the same time. Members may find stock dividends more appealing than other investors.

### **Advantages of Equity Financing**

Equity financing gives your co-op flexibility. For example if your co-op raises enough equity to buy significant assets, it may use these assets to borrow more funds. In this way, your co-op's equity can be used to attract more financing.

Although it is wise to establish a record of paying dividends on preference shares, your co-op (like other corporations) is not legally required to do so. Whether your co-op pays dividends depends on its earnings. By contrast, creditors have the right to sue your co-op for missed interest or principal payments on loans. If your co-op has some difficult times when it is short of cash, it will have more flexibility with a strong equity base.

### **Debt Financing - Incorporating Without Share Capital**

Incorporating without share capital means that instead of buying shares in the co-op, members are required to lend the co-op a minimum amount of money on which interest is paid (currently a maximum of prime plus 2%). Loans are usually long-term to give the co-op stability. To incorporate without share capital and with thirty-five or fewer members, all that is required is the amount of the membership fee, the restriction of the transfer of member loans, the classes of membership and the minimum member loan required, if any.

Should members decide to leave the co-op, they must give six months' notice in writing for the investment to be returned or, if the co-op would find this a financial hardship leading to insolvency, it may pay one-fifth of the investment to the member each year for 5 years.

There are four methods of raising debt capital.

1. **Member Loans:** If your co-op will not be issuing shares, at least some of its financing will likely be in the form of member loans. Member loans are loans required as a condition of membership in a co-op. Co-ops issuing shares may also require member loans.

Like dividends on membership shares, the maximum rate of interest co-ops may pay on member loans is capped at 2% above the prime lending rate of any financial institution (credit union, bank, trust company). Co-ops must repay member loans, together with any accrued interest, when the member leaves the co-op.

2. **Patronage Loans:** Your co-op may also require members to lend it some or all of their patronage returns. Patronage returns loaned back to your co-op are called patronage loans. By requiring members to make patronage loans, your co-op can use its own earnings for debt financing. The maximum rate of interest your co-op may pay on patronage loans is the same as on member loans.
3. **Additional Member, Non-member and Institutional Loans:** If required the co-operative may borrow additional money from members, non-members and financial institutions at the going market rate. The availability and cost of those loans depends on the financial condition of the co-operative and its credit rating.
4. **Debentures:** If your co-op needs to borrow large amounts of money, consider issuing debentures. Specific assets may be used as security by co-ops issuing debentures. If your co-op has fixed assets financed by equity, such as real estate and buildings, it may be able use these to attract investment in its debentures. Co-ops may issue many kinds of debentures but usually they promise to make regular interest payments and to pay off the principal on a certain date. If your co-op fails to make these payments, debenture holders have the right to sue your co-op. There is no cap on the rate of return your co-op may offer investors on its debentures, although you will need to decide how much the co-op can afford. Debentures can also be unsecured.

### Section 3. Operating the Co-Operative

#### Using the Revenue Surplus

Surplus is what is left of earnings after paying operating expenses. How a co-operative uses its surplus can directly affect the financing requirements. The co-op will likely need to keep part of its surplus in the form of retained earnings or reserves. Retained earnings are used to finance expansion in operations or to replace worn-out assets. Determine the operating requirements of the co-op before distributing any earnings to members and shareholders.

Co-ops have traditionally distributed most of their surplus to members as patronage returns. If your co-op plans to attract large amounts of equity by convincing investors it intends to pay dividends on its shares, it will have to balance this commitment with members' desire for patronage returns.

#### Taxation of Surplus Earnings

The method used to distribute the surplus earnings affects the tax treatment of the surplus both for the co-op and its members and investors. Patronage returns are paid out of your co-op's pre-tax income and are recorded as an expense. Paying patronage returns lowers the amount of tax your co-op may have to pay. Patronage returns paid by worker co-ops and some kinds of non-consumer co-ops are taxed as income earned by the member.

Dividends on shares are paid out of the co-op's after-tax income and are taxed in the hands of the member. Co-op shareholders may claim the federal tax credit for dividends paid by the co-op. For specific tax information consult an accountant.

#### Other Co-Operative Regulations and Issues

##### Audit Requirement

The *Co-operative Corporations Act, 1990* specifies that an auditor must be appointed to examine the financial records and make an annual report. The auditor must be impartial and cannot be a director or employee of the co-op. If membership is small and financial assets are limited, an auditor may not be required. No audit is needed if:

- the co-op has fifteen members or less who agree in writing
- fifty members or less who agree by resolution and meet the prescribed maximums for an audit exemption and have no government subsidy or grant that requires an audit

Costs of an audit can be significant and will vary depending on the complexity of the business.

### **Withdrawal of Members**

Member shares of the co-op are personal property and are transferable subject to the conditions in the *Co-operative Corporations Act, 1990*. A member may withdraw from the co-op by giving six months' notice. After the notice period has expired, the co-op must begin to purchase the member's shares or repay the member's loans. A deceased member's shares or loans must be paid out within six months of death. A member can be expelled by a majority vote of the Board of Directors and the co-op must pay out the former member's shares or loans within one year. A member who has voted against a resolution that (in effect) materially changes the nature of the co-op may withdraw their membership and their shares or loans must be paid out within 90 days. A material change could include a sale or disposition of the property of the co-op, amalgamation with another co-op or conversion of the co-op into a corporation.

In each case, the act contains riders giving the co-op the power to delay pay-out of members if the pay-out would render the co-op insolvent or be detrimental to the financial stability of the co-op. A co-op is considered insolvent if liabilities exceed the realizable value of assets or if it is unable to pay debts as they become due.

### **Dissolution**

If members decide to dissolve the co-op, they must first signify their intent by filing Articles of Dissolution with the Ministry of Finance. Member loans and patronage returns rank second after the ordinary debts of the co-operative, which are paid out first. Net surplus is then either apportioned equally among the members or paid out in proportion to the patronage rebate paid over the past 5 years. Alternately, the money may be given to charity. If the method of disposing of surplus funds is not in the Articles of Incorporation or by-laws, the funds will be apportioned equally to members regardless of the number of shares held.

### **Marketing Agreements**

Co-ops that market their member's goods will enter into marketing contracts or agreements with their members. This agreement outlines in writing the rights and duties of the member to market their products through the co-op. It also outlines the terms and conditions under which the products will be marketed and accounted for. The contract is used to assure the co-op of a continuous supply from its members and can contain means of obtaining compensation for damages from the non-cooperating members. It is a contract of either purchase-and-sale or agency and is a vital document for most agri-food co-ops. This can be included in the by-laws.

### **Summary**

Further details of the information in this Factsheet can be found in the *Co-operative Corporations Act, 1990*. Because co-operative incorporation is different from regular business incorporations, it is recommended that advice from professionals familiar with co-operative law and practice be obtained. This document contains only an overview of the *Co-operative Corporations Act, 1990* and should not be used in place of the act.

### **Sources of Information on Co-Operatives**

In addition to the Ministry of Finance, information is available to co-ops from:

- [Ontario Co-operative Association <http://www.ontario.coop>](http://www.ontario.coop)
- [Canadian Co-operative Association <http://www.coopscanada.coop>](http://www.coopscanada.coop)
- [Financial Services Commission of Ontario <http://www.fsco.gov.on.ca>](http://www.fsco.gov.on.ca)
- [Canadian Agricultural Co-operatives Loans Act Program, Agriculture and Agri-food Canada <http://www.agr.gc.ca/eng/?id=1288035482429>](http://www.agr.gc.ca/eng/?id=1288035482429)
- [Innovation, Science and Economic Development Canada <http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h\\_cs03926.html>](http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h_cs03926.html)
- [Center for the Study of Co-operatives <http://www.usaskstudies.coop>](http://www.usaskstudies.coop)
- [Agricultural Business Information - OMAFRA Business Development <http://ontario.ca/agbusiness>](http://ontario.ca/agbusiness)

### **References**

Co-operatives in Ontario, FSCO, a series of publications that includes: Guide to Setting Up A Co-operative, Incorporating a Co-operative With Share Capital, Incorporating a Co-operative Without Share Capital, Legal Requirements.

[Creating a Co-operative, Innovation, Science and Economic Development Canada](http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/cs03954.html)  
<<http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/cs03954.html>>

This publication is intended as general information and not as specific advice concerning individual situations. Although it outlines some of the legal and tax considerations of co-operatives it should not be considered as either an interpretation or complete coverage of the Income Tax Act or the various laws affecting incorporation of co-operatives. The Government of Ontario assumes no responsibility towards persons using it as such.

## **Appendix 1. Steps in Forming a Co-Operative**

### **Phase I - Develop the Initial Business Idea**

#### **Step 1: Assemble a Group of Key Organizers**

- Identify the needs or issues that the co-op would address such as:
  - opportunities for value added processing
  - unavailability of certain products and services
  - poor quality of certain products and services
  - products and services overpriced
  - market development
- Identify professional assistance needed to launch the business:
  - legal consultant
  - co-operative development consultant
  - feasibility study, business plan and financial consultant
  - accounting consultant
  - Form a steering committee to guide the feasibility study.

#### **Step 2: Conduct a Feasibility Study**

- This includes market, production, cost, sensitivity and financial analysis.
- Identify available technical and financial assistance.
- Assess receptiveness to the co-operative business in the local community.
- Evaluate if the co-op is the best legal framework to use or if the kind of co-op selected is the most suitable.
- Define the intended benefits of the co-operative for members (e.g., quality, price) and characteristics:
  - products and services offered (consumers' co-operative)
  - products and services marketed (producers' co-operative)
  - salaries and working conditions (workers' co-operative)

Evaluate the project's potential to attract the minimum number of members required. If this study is not conclusive, re-evaluate the business idea. If this study shows that the planned co-operative is feasible, the group can proceed to the second phase.

### **Phase II - Co-Ordinate the Pre Co-Operative Activities**

Steps three and four may occur at the same time or may occur in the reverse order as shown here. Developing a business plan may be difficult to direct or complete unless at least a temporary structure is in place.

### **Step 3: Hold an Organizing Meeting**

- Choose the corporate name of the co-operative and the location of its head office.
- Define the co-operative's mission (objectives, purpose).
- Elect an interim Board of Directors and secretary to the board.
- Officially submit an application for incorporation as a co-operative to the Financial Services Commission of Ontario or to Industry Canada, if you are incorporating federally.

### **Step 4: Complete a Business Plan**

- Choose a business planning team.
- Obtain financing for the business plan from such sources as internal financing by the members, special grant and/or negotiate a technical assistance or business start-up agreement with a specialized organization.
- See [Appendix 2](#), Developing a Business Plan

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If the business plan reveals serious flaws or the group's level of enthusiasm for the plan is low, the interim board members may decide to terminate the project. If the opposite is true then the group can proceed to Phase III.

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## **Phase III - Organize and Start Up the Co-Operative**

Set up ad hoc committees to distribute the workload among the members of the interim Board of Directors. For example:

- planning committee
- financing committee
- property committee

### **Step 5: Organize the Internal Structure of the Co-Op**

- Decide on the co-op's structure and define the various categories of members, if necessary (consumers, suppliers, workers).
- Determine the roles and responsibilities of the various democratic bodies (general meeting, Board of Directors, committees).
- Establish the articles and by-laws.
- Recruit members.
- Provide appropriate director training.

### **Step 6: Plan and Organize the Co-Op's Start-Up Financing and Funding Drive**

- Determine the value of the membership share to become a member (for example, \$5 or \$50).
- Evaluate the value of the share capital on start-up and during the first three years of operation (in terms of the expected growth in the number of members).
- Draw up the overall financing plan for the first three years of operation.
- Refine or review the business plan.
- Negotiate the capital contribution of external financial partners (if necessary): venture capital corporations, private funds, caisse populaire or credit union investment programs.

- Negotiate medium term credit union or bank loans and a line of credit.

## **Step 7: Organize the Business Enterprise**

### **Step 7A: Plan the Operation of the Co-Op**

- Draw up an organization chart of the co-op.
- Do the operational planning for the first year of activities.
- Negotiate contracts for the supply of necessary products and services (inputs) and, as required, sales or marketing contracts (depending on the kind of co-operative and the nature of the enterprise).
- Devise and implement an accounting system.
- Define the duties and responsibilities of each position.
- Develop a salary policy.
- Select and recruit the person to occupy the position of Chief Executive Officer/General Manager.

### **Step 7B: Recruit and Train the Co-Op's Staff**

- Select and recruit employees.
- Organize and offer a staff training program.

### **Step 7C: Ensure the Legality of the Co-Op's Operations**

- Obtain the legal authorization necessary to start up the co-op's activities: municipal, provincial and federal governments.

## **Step 8: Hold the Initial General Meeting**

- Adopt the by-laws.
- Approve the co-operative's membership in a sectoral federation or other co-operative organizations.
- Appoint an external auditor.
- Elect the members of the Board of Directors, and of any other committees.

## **Appendix 2. Developing the Business Plan of a New Co-Operative**

A business plan is a document providing a complete description of the co-operative enterprise you wish to form. It describes in detail the products or services that will be produced or sold, the organization of work, the management approach, the results of the market study and the marketing plan, the human resource plan, equipment and material needed, financing requirements and the financing plan.

The business plan is a work tool. It serves two purposes:

1. To facilitate the acquisition of external capital, credit union/bank loans or grants. It must explain to investors why they should invest in the enterprise and your team's ability to launch and develop it successfully.
2. To facilitate control of the process of launching and developing the new co-operative.

It will be a blueprint for launching and monitoring the co-operative's activities and results. It must be written in clear and straightforward language.

A business plan contains the following sections:

1. Summary of the business plan (two pages maximum).
2. Brief description of the co-operative (one page):
  - name, address of the head office, date formed

- o type of co-operative, objectives, number of members

### 3. Analysis of the co-operative's market

- o Brief description of the characteristics of the products or services offered with respect to comparable products and services available on the market
- o Characteristics of the market, size, parts of the market held by competing enterprises, market segments, market trends
- o Characteristics of your sales strategy (direct, through third party, shipping costs, etc.)
- o Characteristics of the clientele (members or non-members), age groups, gender, occupation, family income, location, buying habits, etc.
- o The price of your products or services

### 4. Description of products and services

- o The originality of the products and services compared to what is available from the competition, their distinguishing characteristics (include photographs or sketches if necessary)
- o Description of any research and development activities required before they can be marketed (give associated costs and timetable)
- o Description of new products and services development plan
- o List of legislation that must be complied with and legal authorizations that must be obtained before they can be introduced on the market

### 5. Marketing plan

- o Estimate of sales for the first three years and the market share sought (refer to your detailed market study on which you based your sales)
- o List of buyer-members or potential buyers who have already expressed an interest in buying
- o Description of market segments targeted (size, location, other characteristics)
- o Description of your strategic market penetration plan and its cost (how you will advertise your products and services, promotion campaign, media publicity, discounted membership prices, etc.)

### 6. Operations

- o Advantages of the location of your place of business
- o Characteristics and costs of the building and equipment already owned or to be bought or leased (attach a plan if necessary and refer to detailed descriptions in an attachment)
- o Description of the process and methods of producing the products and services
- o Description of the characteristics of the manpower required (professional qualifications, number, salary costs, etc.)

### 7. Management and organization

- o Characteristics of the co-op's structure and method of operation (division of powers and responsibilities, names of the directors and a brief description of their expertise)
- o Organization chart of the co-op and the method of operation (management philosophy, names of managers, their qualifications, a description of their duties, their responsibilities and reporting relationships)

- Identification of external professional resources with whom you plan to deal (organization specializing in start-up assistance, accounting firm, marketing consultant, trainer, etc.)

#### 8. Timetable of activities

- Projected financial statements to include:
  - Statement of assets and liabilities for the first three years
  - Statement of earnings for the first three years
- Projected cash budget for the first year, estimate of working capital for the following two years
- Break-even point (level of revenue beyond which the co-operative will generate a surplus, after fixed and variable costs are subtracted)

#### 9. Financing plan

- Total investment needed for start-up
- Short and medium-term investment plan
- Source of funds (share capital, external investors, medium-term loans, etc.)
- Amounts by source, conditions of acquisition (interest, share of surplus, etc.), repayment schedule, security given

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For more information:

Toll Free: 1-877-424-1300

Local: (519) 826-4047

E-mail: [ag.info.omafra@ontario.ca](mailto:ag.info.omafra@ontario.ca)