ANALYSIS OF DRAFT CONSTITUTION

NEW INDUSTRY GOOD ORGANISATION -

MEAT + WOOL BOARDS

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PRELIMINARY COMMENTS

This report focuses on four main issues:

- The choice of corporate form for the new organisation;
- The meaning of *'industry good'* and how it is applied in this case;
- The proposed ownership structure, with particular focus on with the way owners' rights have been fragmented; and
- The proposed board structure, in particular the reservation of two positions for meat processors and exporters.

In the course of reviewing the draft constitution, I have come across a range of technical issues which can be divided into two groups: the first is a set of drafting concerns that could have a significant impact on governance; the second is a set of minor drafting points which may be of assistance to the people preparing the constitution. I will write these up and forward these if you request them.

CHOICE OF ORGANISATIONAL FORM

The Commodities Levies Act 1990 does not prescribe the corporate form a levying raising organisation must have. Any body corporate may levy if it satisfies the statutory requirements relating to how the levy is raised and how it is used.

Given that commodity levies cannot be used for commercial purposes, organisations raising levies are ordinarily incorporated societies or bodies of a similar character where the primary aim is *not* to increase the value of members' capital.

The company form is normally used where an organisation's primary goal is to aggregate capital and take business risks with a view to increasing the value of the members' capital.

It is therefore curious that the Meat and Wool Boards are proposing to incorporate their new industry body under the Companies Act 1993. There could be three reasons for this:

- The new body is to have dual purposes: part '*industry good'*, part commercial;

- A company may be viewed by its promoters as having a better brand. In short, it sounds better, more business-like; and/or

- Establishing a company may be a way of retaining accumulated tax losses in businesses which are to be transferred to the new body.

I would surmise the promoters' rationale is a combination of all three, so I offer a brief comment on each consideration.

The choice of corporate form should not be driven by tax issues. If these are material, there are likely to be other, less distorting ways of protecting tax losses.

Nor should the choice of corporate form be driven by branding. A company may sound more business-like compared to an incorporated society, but this connotation can be achieved by other means (such as efficient performance) which avoid the complexities associated with trying to adapt the profit-orientated features of a company to the non-profit orientated objects of an industry good body. As noted below, the draft constitution is strained in trying to achieve this adaptation.

The new body's promoters are likely to see it as having dual objectives: *'industry good'* and commercial. This is clear from the mixture of Principal Activities in clause 1 of the draft constitution *(discussed further below)*. It is also clear from the range of other investments the new organisation is intended to hold, such as Ovita.

Dual objectives create a major problem, for at least two key reasons:

- Organisations with competing objectives tend not be successful. Dual objectives create confusion and ambiguity. It is now well established in modern corporate governance that successful organisations have a clear and single primary goal.

- An organisation with dual roles – one, seeking to earn profits and grow wealth; the other, spending compulsory levies on *'industry goods'* – has both the means and the incentives to 'mix' each function. It is inevitably *very* difficult to ensure a clean separation of receipts and expenditures, costs and revenues, between the two sets of activities. The risks of 'blurring', with its resulting erosion of accountability and performance, are high.

Recommendation 1

Establish separate entities: a company for commercial activities, an incorporated society for *'industry good'* activities.

DEFINITION OF '*INDUSTRY GOOD*'

Concept

This is a pivotal definition. Before focusing on detailed wording, consider the underlying concept. It is simple but widely misunderstood.

For many years, an *'industry good'* has been viewed in both the meat and wool sectors as *'something good for the industry agreed by wise men acting with the greater interests of the industry at heart'*. Supported by a statutory power to levy without requiring a vote of levy payers, the relevant producer boards have each developed a large body of activities which they view as falling within this broad notion of *'industry good'*.

In truth, *'industry good'* is a much narrower concept. Not surprisingly, many industry leaders try to refute or avoid it. But its key elements are not in dispute. An *'industry good'* is an activity where:

- Total benefits are reasonably likely to be greater than total costs; and
- The people willing to invest voluntarily cannot capture enough of the benefits to cover their share of the total costs. This is often because the spread of benefits cannot be easily confined.

The normal policy and business response is to look for ways to control the flow benefits. Patents, trade marks, copyrights, contracts and physical restrictions on access to assets are all examples.

Free-Rider Test

The fact that 'free riding' occurs does not mean the activity is necessarily an *'industry good'*. 'Free riding' occurs in many commercial activities (for example, large amounts of intellectual property spill to competitors and consumers who do not pay). The existence of 'free riders' is therefore not the key.

What counts is whether those willing to invest voluntarily can capture enough of the benefits to cover their share of the costs. It does not matter if they cannot capture all the benefits.

If they are able to corner enough benefits to provide an adequate return on their investment, the project is likely to proceed. If not, it probably will not and, without Government intervention, the economy would miss out on the net benefits the project was expected to generate.

The power to levy is therefore provided by the Government to counter this problem. Rather than seeking to restrict the flow of benefits, a levy forces everyone able to receive benefits to contribute to the activity's costs.

Reliance on Levies Test

It follows that *'industry goods'* are ordinarily funded from compulsory levies. If the activity would otherwise occur using voluntary non-government funding, it is not likely to be an *'industry good'*. Funding of an *'industry good'* by private individuals or private organisations may occur, but it is rare given that such funding is, in effect, an act of private charity – a field in which donors tend to focus on other areas of public need.

A fundamental error is therefore evident in clause 1.2 of the draft constitution, which states that a principal activity of the new organisation is:

"raising money to fund Industry Good Activities from such sources as the Board thinks appropriate, including:

b) investment by private organisations;
c) exploitation of intellectual property owned by the Company…
d) funding made available by the Meat Board (including but not limited to reserves interest or capital)"

If funds can be raised from any of these sources, the activity is not likely to be an *'industry good'*. It is simply another privately funded venture. As noted above, exceptions can occur of private funds supporting *'industry goods'*, but these are unusual. Government-enabled funding is normally required.

In addition, if benefits can be captured under intellectual property rights relating to the activity (as contemplated under (c) above), the activity is not likely to qualify as an *'industry good'.*

Net Benefits Test

The critical test in deciding whether a proposed activity is an *'industry good'* which justifies compulsory levy funding is whether it is likely to generate net benefits. If not, all other considerations are irrelevant.

Rigorous commercial judgement is needed in making this assessment. The vital question is, would well-informed voluntary investors conclude that total returns are likely to cover total costs on a risk-adjusted basis? Many commercial proposals fail to get off first base because promoters cannot persuade enough investors that sufficient net benefits are likely to accrue.

It is a major risk in exercising a compulsory levy power, therefore, that promoters may use it to override the judgement of individual investors who would not otherwise invest because, in their individual opinions, total benefits are not likely cover total costs on a risk-adjusted basis.

Assessment of expected costs and benefits by an industry organisation seeking to raise a compulsory levy should have two steps:

- First, using rigorous and objective analysis, the organisation must determine whether total benefits are likely to exceed total costs. Short cuts, wishful thinking, vague assumptions and broad gut feelings, which have so characterised supposed *'industry good'* schemes promoted by the Boards over the years, are *not* acceptable substitutes. Each proposal needs to be assessed, on an individual basis, not as part of a broad category of activities.

- The industry organisation must then ask whether reasonably well-informed investors are likely to reach the same conclusion. This 'check' against the promoters' unavoidable (often subconscious) bias is essential.

It is important to keep in mind that promoters who are *not* investing their own money have a significantly different incentives from private investors who are. Not surprisingly, the two perspectives on risk, reward and opportunity costs (that is, what else an investor can do with his or her money) tend to be very different. This is why it is so important for an industry organisation promoting an activity for compulsory levy funding to 'check' its innate and quite natural incentives to assume net benefits.

In short, it is not enough for an industry organisation to say that voluntary investors would turn down a proposals with apparent net benefits and therefore it can be classed as an *'industry good'* justifying compulsory levy funding. The organisation must ask why and is there a strong case for overriding investors' judgement.

Conclusion

A proposed activity is only an *'industry good'* if:

- Rigorous analysis establishes that it is likely to generate total benefits greater that its t otal costs; *and*
- It is likely that well-informed investors would agree with this analysis; *and*
- It is highly likely that potential voluntary investors could not capture sufficient benefits to cover their share of the total costs; *and*
- With rare exceptions, the activity can only proceed if it is funded by a compulsory levy or Government funding.

If *all* of these conditions are satisfied, then the proposal can properly be viewed as an *'industry good'* for which compulsory levy funds may be sought.

Constitution's Presumption of 'Industry Goods'

In reality, a large proportion of supposed *'industry good'* activities undertaken by both Boards' over the years have not been subjected to proper analysis and are not, in fact, *'industry goods'*. The Boards have simply classed them as such on the basis of tradition, public relations branding and farmer acquiescence.

This is reflected in the way the Statement of Principal Activities in clause 1 of the draft constitution is framed. It tends to imply that the listed categories of activities are inherently *'industry goods'.* Given that a constitution is an agreement among shareholders, the implication is that farmers agree that these activities are, by nature and history, *'industry goods'.*

This is not reasonable or logical. Among other things, each proposed activity needs to be assessed on its merits and on an individual basis, not as part of a broad category of activities, against the *'industry good'* criteria. Some may pass, others may not. It is not for the constitution to imply any degree of predetermination or presumption.

At best, the constitution should re-frame clause 2 and express each category as an objective or purpose. Whether these purposes become levy-funded activities must depend on whether particular proposals satisfy the *'industry good'* criteria.

An alternative would be to refer to the clause 2.1 activities as principal activities using other sources of funds (as contemplated in clause 2.2). In any event, clause 2.1 activities should not be referred to as *'industry goods'*.

Recommendation 2

Page 27 of the draft constitution: change as follows –

"***Industry Good Activities*** *means an activity directly ~~or indirectly~~ related to the business of farming Livestock that is expected to provide net benefits ~~(either~~ directly ~~or indirectly)~~ to Farmers or a group of Farmers, in that total benefits ~~should~~ are reasonably expected to exceed total costs to Farmers or a substantial proportion ~~group~~ of Farmers (such proportion to be ~~as~~ determined by ~~at the discretion of~~ the Board), but which would not be provided by voluntary means ~~sufficiently provided by the market~~ because:*

(a) the benefits of the activity flowing to those prepared to pay for it voluntarily would not be sufficient to cover ~~the costs of the~~ their costs in funding the activity ~~activities~~, even if other persons benefit without paying; ~~or~~ and

(b) it would not be practical to prevent others from benefiting from the activity ~~who did not contribute towards~~ without paying sufficient ~~for~~ to cover the costs of the activity ~~from benefiting from the activity~~"

Alternatively, make the changes to (a) above but delete all of (b).

Recommendation 3

Page 1 of the draft constitution: re-frame clause 2.1 as a set of objects, not principal activities, recognising that the constitution should not imply in any way that certain activity categories are presumed to be *'industry goods'*.

A revised statement of principal activities could note that a principal activity of the organisation is to undertake projects that satisfy the *'industry good'* criteria (set out on page 27, as modified above). (Note that a statement of principal activities in relation to *'industry goods'* is not necessary from a legal perspective).

Recommendation 4

Page 1 of the draft constitution: change clause 2.2 to link levy funding (in 2.1(a)) exclusively with *'industry good'* activities. Activities funded from other sources, as referred to in clause 2.2, are not *'industry goods'.*

Recommendation 5

Add to provisions in the draft constitution on a process for determining whether a proposed levy activity is reasonably expected to deliver net benefits for potential levy payers. In particular, the constitution should require a cost/benefit analysis, that it be in writing and quantified, that appropriate investment analysis techniques are to be applied, that it be impartial, that it set out all major assumptions, that it explain any material information deficiencies, and that it note any material adverse impacts on other persons (other than potential levy payers). This information should also be available to potential levy payers before any levy vote.

Recommendation 6

Page 1 of the draft constitution: clarification of clauses 1.3 and 1.6 may be required. In particular, why do the promoters view these activities as distinct from the rest? Also in clause 1.5, how is *"representing…Farmers'…interests in relation to…the red meat and wool industries"* likely to be distinct from *"representing…Farmers'…interests in relation to…Industry Good Activities"*? The latter likely to be a subset of the former. Best to change clause 1 as a whole into a statement of objects.

Clause 2 of the draft constitution: this provision should be deleted. It negates the primary purpose of clause 1, which is to set parameters around the organisation's activities. By contrast, the Dairy Insight constitution does not have such a provision. Indeed, its powers are expressly restricted to its stated objects.

OWNERSHIP STRUCTURE

Competing Ownership Interests

The draft constitution refers to four classes of persons who would be ordinarily be regarded as holding certain rights relating to the ownership in an organisation:

- Farmers (as defined - [note that upper case expressions are terms used and defined in the draft constitution]). A Farmer is a person who has made a Declaration that he or she farms the Minimum Livestock Threshold;

- A farmer who farms Livestock in an Electoral District (see Schedule 3, clause 5.1). This is a person who is not a Farmer (as defined) but would become one upon making a Declaration in relation to the Minimum Livestock Thresholds;

- A Levy Payer. This is a person who farms and owns Livestock. The definition of Levy Payer is similar to a 'farmer who farms Livestock' referred to above, but there are some interesting technical differences outlined below; and

- A shareholder. This is not defined expressly in the constitution, but a Farmer is not a shareholder. This is discussed further below.

But first, an interesting technical point in relation to these four competing categories of people with ownership interests:

- A Levy Payer is required to *own and farm* Livestock.

- A person becomes a Farmer under clause 5.2(a) without having to *farm* the Minimum Livestock Threshold, only *own* it [see also clause 5.2(b)(ii)].

- However, a person making a Declaration under clause 5.2(b)(i) to become a Farmer is required to *farm* the Livestock, not *own* it.

Whether these differences are intentional or accidental is not clear. They need to be clarified to avoid confusion and potentially significant administrative problems.

The more important issues in relation to ownership structure are:

- The fragmentation of ownership rights between shareholders and Farmers; and

- The lack of clarity about the ownership rights of Levy Payers who are not Farmers because they do not have the Minimum Livestock Threshold – they appear to have none. (This issue is not covered in this report);

Shareholder vs Farmer Rights

Most levy payers are likely to be Farmers. If levies are treated as the equivalent of capital subscriptions in the new company, Farmers are, in economic terms, the company's real shareholders. It is reasonable to expect, therefore, that the normal rights and powers of shareholders should be allocated to Farmers.

Under the draft constitution, however, a Farmer is not a shareholder. A Farmer's rights are set out in clause 7. Compared to the normal rights of a shareholder, which are set out in section 36 of the Companies Act 1993, a Farmers does *not* have:

- The right to remove directors;
- The right to approve major transactions;
- The right to share equally in any dividends;
- The right to share equally in any distribution of the Company's surplus assets; and
- The right to approve the initial constitution.

Except for the right to remove directors, these rights are reserved exclusively for shareholders under clause 66 of the draft constitution. Shareholders also have the exclusive right to approve Technical Amendments to the constitution. The normal right to remove directors does not appear to be conferred on anyone.

So, who are the shareholders? Under clause 69 of the draft constitution, the board may issue shares to *"any person, and in any number it thinks fit provided…..person will hold the Shares in trust pursuant to the terms of the Trust Deed for the benefit of Farmers".*

The terms of the Trust Deed are not known to the writer. However, they are clearly of equal importance to the constitution in relation to governance. Without reviewing the Trust Deed, its impact on Farmers and governance efficiency cannot be determined.

The separation of shareholder and Farmer rights raises a range of issues and concerns. It offers opportunities for 'skewing' voting power on major decisions in favour of shareholders. The organisation's promoters will no doubt claim that this is only theoretical, and that Farmers can rely on directors not to do this. However, there are no legal restraints on directors issuing additional shares in any number. While use of this power may appear theoretical today, the situation could easily change in the future when opportunistic behaviour is encouraged by constraints and pressures.

Note also that directors are not fully accountable to Farmers until the fourth year. Some members of the interim board appointed two weeks ago will stay in place as of right for the first three years. But even ultimate exposure to the ballot box every three years is not a sufficient discipline on the wide powers conferred on directors to issue shares to trustee shareholders who contribute no capital but have exclusive powers to exercise some of the most significant rights.

It is not clear from the draft constitution whether the rights conferred on shareholders under clause 66 are exclusive of other shareholder rights set out in the Companies Act 1993. If not, then, except for electing directors, shareholders will be able to vote on all Farmer resolutions.

Even if clause 66 is exclusive of other shareholder rights conferred by the Companies Act 1993, shareholders will still be able to vote on all Farmer resolutions *except* direction elections and director remuneration.

The key questions are therefore:

- Who controls the number of votes (shares) issued to the trustee shareholders relative to Farmers? and

- Who controls how the trustee shareholders vote?

The answer to the first question is, the directors without any express fetters. The answer to the second question depends on the terms of the Trust Deed (which the writer has not seen).

Recommendation 7

Unless there are absolutely compelling reasons to keep it (which are not evident to the writer), the separation of shareholder and Farmer rights should be removed from the draft constitution. Farmers should be shareholders (or if the organisation is an incorporated society, members) with all normal rights and powers. The role of the trustee shareholders should be abolished.

If a strong case can be made for a trustee shareholder, then important technical changes are required to various parts of the draft constitution to properly safeguard Farmers' interests in relation to the exercise of powers by or for shareholders. For example, directors' power to issue shares under clause 69 must be subject to an ordinary resolution of Farmers approving any proposed share issue. Such protection is expressly contemplated in section 44 of the Companies Act 1993.

Recommendation 8

On a technical drafting level, clause 7(1)(i) of the draft constitution asserts that only trustee shareholders can vote on, among other things, any resolution to change the company's name. However, clause 7(1)(e) also confers on Farmers the right to vote on any such resolution. This needs to be clarified.

BOARD OF DIRECTORS

Board Size

A board of nine is proposed. From the third AGM, it is to comprise six directors elected by Farmers (three from the North Island, three from the South Island), two from the meat processors and exporters and one appointed by the board.

A range of technical issues arises in relation to the various election processes and board powers. These can be provided if requested. One issue to note now is the puzzle as to how clause 39.1 of the draft constitution works with the rest of the director provisions. Clause 39.1 allows the board to shrink to six in total. Salient questions are:

- Who goes if the size is reduced? Elected directors? Exporter directors? The independent? and
- Who decides – both who goes and what number the board should be between six and nine? The trustee shareholders? Farmers? By ordinary or special resolution?

These are issues that could have a significant bearing on governance and quality of accountability.

Recommendation 9

Amend the draft constitution to clarify that any changes to the number of directors within the range in clause 39.1 are to be decided by an ordinary resolution of Farmers.

Role of Exporter and Processors

Turning to the key issue of whether processors and exporters should have reserved board positions and a separate election process. The rationale is not clear. I would surmise it is largely an extension of current practice at the Meat Board. I am not familiar with its history, but it is reasonable to assume that the practice evolved over a series of pragmatic, rather than principled, decisions designed, no doubt, to foster 'closer and more effective working relationships between farmers, the Meat Board and meat processors and exporters'.

Politics is an necessary and unavoidable part of how the industry works. However, it is still important to reason through how the board should be structured from a first-principles perspective.

In essence, a large number of individuals (farmers) are merging together to form a single body to which each will contribute funds on a compulsory basis for the purpose of investing in projects that are expected to generate net benefits for all farmers.

The farmers collectively are delegating wide powers of control to a small group of agents – the directors. It is, at its heart, a principal-agent relationship. The constitution is the set of rules established by the farmers for regulating and holding to account their agents.

From this perspective, there is no case for meat processors and exporters to have automatic rights to any number of director positions.

Processors and exporters do not pay levies. These are deductions from payments that would otherwise be made to farmers. Some may argue that, in substance, the levy amount comes from processors – that if the levy was not deducted, the processors would retain it for their own benefit, and therefore the levy represents a retention that processors are forgoing.

At law, this argument is dubious. It is clear in other similar levies that processors are collection agents. Under the Levy Order put in place for the dairy industry earlier this year, dairy companies are simply the collection agents. Dairy farmers pay the levies. Similar legal definition is likely in any Levy Order for the meat industry.

If this is so, it is clear that meat processors and exporters are not to be regarded as levy payers. And on first-principles, there is no case for them to vote on any directors.

If the law were to define them as levy payers, they should have the same rights in relation to voting for directors as any other levy payer.

In either cases, there is no basis for reserving separate positions on the new board for processors and exporters. On the contrary, economic and legal arguments would tend to support the opposite conclusion.

It is not disputed that NZ domiciled processors and exporters share a common interest in protecting and promoting the overall integrity and reputation of NZ's export activities. However, as viewed by processors and exporters, the new organisation's farmer-supplied funds represent a significant source of potential funding to subsidise their own commercial activities.

Put plainly, the levies and reserves are a source of 'soft money' – considerably cheaper for processors and exporters than using their own. Many processors acknowledge this privately. Their commercial incentives are clear and, from a business perspective, entirely rationale – get the money if it is available.

From farmers' perspective, however – the people who supply and own the funds – giving the processors automatic representation at the board creates a built-in distortion and a conflict of interest which can readily be avoided without disadvantaging the new organisation.

It is clearly of considerable importance to work closely with processors and exporters– this is not in dispute. However, these outcomes can be achieved using a range of other less distortionary mechanisms, including advisory groups and structured consultation processes.

The relationship that needs to given primacy is between levy payers (farmers) and their agents (directors). In the environment of broad-based compulsory levies, making this relationship work well is hard. Automatic board membership by processors and exporters offers no benefits that cannot be achieved by other means. On the contrary, it carries significant risks of, over time, weakening the paramount governance relationship between farmers and their directors.

Recommendation 10

Remove the separate positions reserved for meat processors and exporters on the new board.

If processors and exporters are not levy payers and do not otherwise contribute equity capital to the new organisation, confer no any rights on processors and exporters to vote on any board membership.

Recommendation 11

Change clause 38 of the draft constitution to require all Initial Directors to retire after 12 months and allow Farmers to elect all directors (except for one appointed independent) at the first AGM.

This was done at Dairy Insight.

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