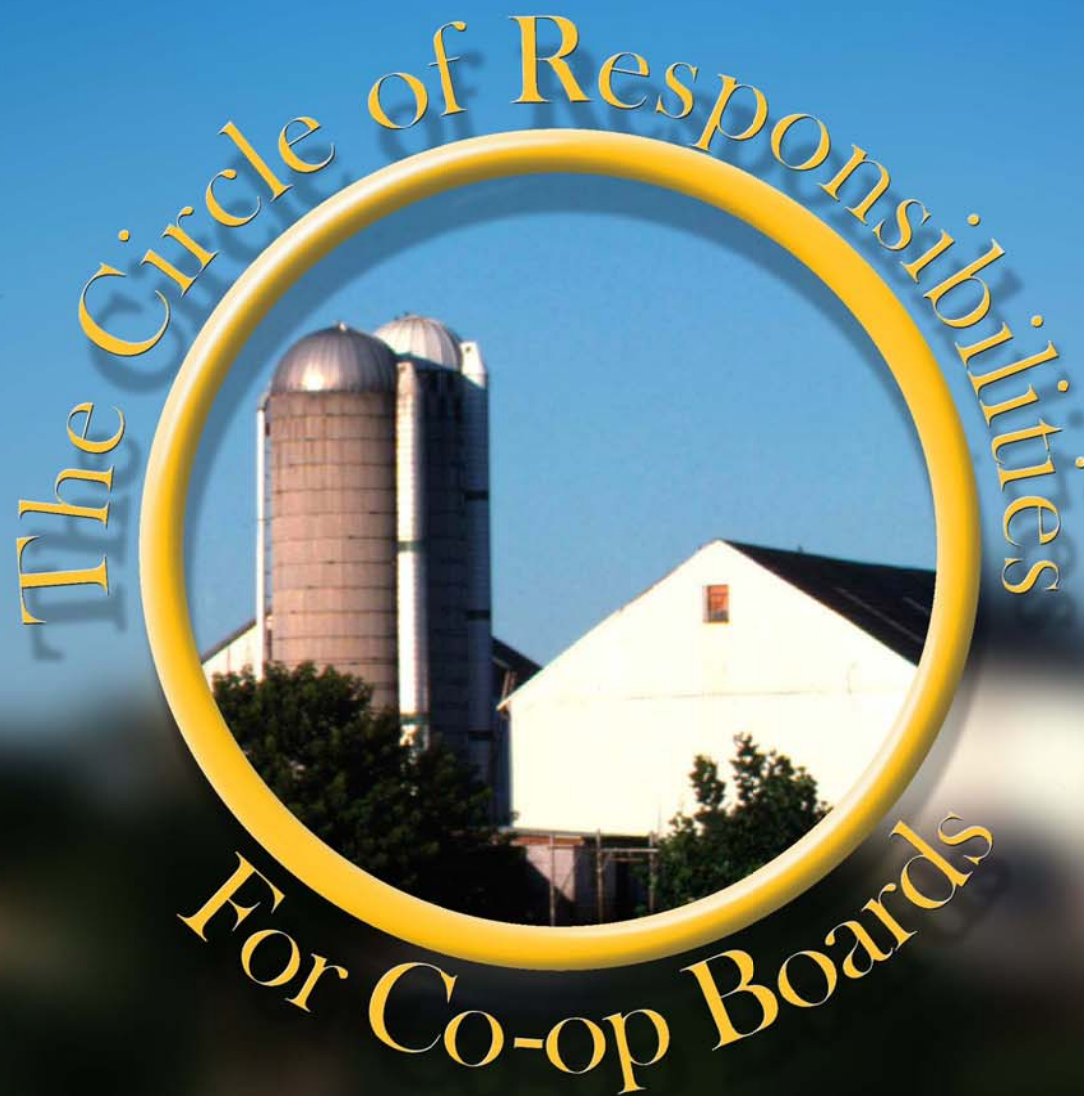


Rural COOPERATIVES



A Reprint of the Management Tip Series by James Baarda

Foreword

All boards of directors are under increasing pressure to perform well and justify their decisions. Cooperative boards are no exception. But increasing scrutiny of director behavior is not always accompanied by better information about exactly what directors are supposed to do and how they are to perform their many duties.

The series of articles reprinted here originally appeared during 2002 as Management Tip articles in three issues of USDA's "Rural Cooperatives" magazine. These articles lay out fundamental guidelines for cooperative directors. Along with practical guides, the articles explain underlying principles and give suggestions for specific actions cooperative boards and directors can take to improve their service to cooperatives.

Cooperative members can use this well-received series to assess board and individual director performance and make informed choices about directors. Directors can apply the information to carry out the full range of their responsibilities with the assurance that they are satisfying the high standards of conduct required of them.

Questions about cooperatives?

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Co-op boards' circle of responsibilities

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Editor's Note: *This is the first of a three-part series about cooperative boards of directors. This article identifies the sources of authority for boards and describes seven basic responsibilities imposed on every cooperative board of directors. The next article discusses the legal standards directors must meet and outlines practical ways directors can protect themselves as well as the cooperative. The last article describes the numerous special difficulties faced by cooperative directors and shows why a cooperative director's task is more difficult than for directors of other organizations.*

Being a director of a cooperative isn't easy. In fact, it is harder to be a good cooperative director than a director of almost any other organization, including the largest corporations in the country. Cooperative directors make decisions that aren't required in a non-cooperative corporation, and bad decisions can hurt the cooperative and all of its members.

Frequently, directors just have too little information about what they need to do as directors. Information that is available to help them become excellent directors is often not appropriate for cooperative directors. Often, advice is so general it isn't applicable and some is so specific that it cannot be applied easily. Advice and information may not focus on the real issues and sometimes the advice is conflicting.

The three articles in this series certainly don't give all the answers. However, existing information related to cooperative directors, as well as the directors of other kinds of organizations, can be distilled and focused for cooperative director use. Concise guidelines are given that can be tailored to the needs of individual directors on the boards of a specific cooperative.

This article identifies authority that gives directors the rights and responsibilities to carry out their work as directors on behalf of the cooperative and its members. Then it describes the seven basic responsibilities imposed on all directors of all cooperatives: the "circle of responsibilities."

Board authority

What gives a board of directors its authority? The basic authority, and the ultimate statement of responsibility, is imposed by law. Statutes under which cooperatives are incorporated identify the board of directors as the key institution responsible for the direction and management of the cooperative. A typical cooperative statute says: "The affairs of the association shall be managed by a board of not less than five directors, elected by the members or stockholders from among their own number." Variations exist, of course, among statutes and states, but the theme is always the same: the law places a cooperative's management and guidance in the hands of its board of directors.

The statutory mandate is broad but isn't described in further detail by most statutes. This is one reason that further explanation is needed to make the direc-

tive meaningful. An added source of guidance is a cooperative's own bylaws. The bylaws are not the place to give detailed descriptions of what the board is supposed to do, and bylaws typically do not. However, in describing certain processes and actions of the cooperative, bylaws often identify decisions the board must make on specific issues. Some of these will be described when board function and personal responsibilities are noted in the next article in this series and— even more so—when special issues are described for directors in the final article. The problem faced by directors (who represent members) when members want something that will be detrimental to their cooperative (to whom directors also owe a duty) is also noted in the final article.

Finally, the board will establish its own internal structure, rules and operations to supplement the broader statements in the statutes and the bylaws. These cannot remove or diminish the responsibilities imposed by statute, but can create a framework in which the overall responsibilities and authority are useful in the everyday work of the board.

These are the technical sources of authority. The ultimate authority, though, comes from the cooperative's members. The cooperative is theirs, and without members' desire to create and perpetuate the cooperative, the board would not exist. Members place their trust, their needs, and authority in a board of directors of their own choosing.

Circle of seven responsibilities

Despite significant differences among cooperatives in the United States in

size, function, complexity, organizational form, financing methods and membership makeup, it is possible to summarize a “circle” of seven responsibilities applicable to all cooperative

thorough understanding of the cooperative’s resources and its employees so they can be used to the members’ best advantage in a successful cooperative.

2. Board establishes cooperative policies

Directors put their member representation role into effect by making policy. Indeed, many discussions about cooperative directors summarize the board’s job as establishing cooperative policy. Policies may be broad and long-range or they may be specific and immediate. Both are necessary. If the board fails to establish cooperative policy, either someone else will establish the policy or the cooperative will operate without direction and control. In

to serve patrons in one way or another. An overall responsibility of the board is to establish policies with respect to acquisition and preservation of the cooperative’s assets. Cooperatives are entrusted with other people’s money and must account for it at all times. The assets of a cooperative were purchased with member money, and the cooperative is obligated to those members.

This board responsibility is shown in two specific obligations. First, the board is responsible for guaranteeing that the cooperative establish and use accounting systems that keep track of all aspects of the cooperative’s finances and resources. The accounting system must also accurately reflect the true financial condition of the cooperative.

The second obligation is that the board monitor the cooperative’s financial performance and establish policies that protect the cooperative from financial shocks and risky situations that undermine its financial health. Proper audits and careful board response to audit reports is the first step towards meeting this responsibility, but a range of board decisions can spell financial success or failure.

Whether financially related policies are short-term or long-term, the board of directors has the ultimate responsibility for the cooperative’s financial affairs.

It is clear that these responsibilities require a great deal of care, attention, and skill by

each member of the board. Board members must understand what a financial reporting system is, what it must do, and what financial information can and cannot tell directors about the performance of the cooperative and its management.

5. Board preserves the cooperative character of the organization

The board, as the policy-making body and representative of the cooperative’s members, is responsible for maintaining the special character of the cooperative. If the cooperative is

General definitions:

Responsibilities: What boards of directors must do to meet their obligations to the cooperative under laws and other guiding sources.

Standards of conduct: Sometimes called duties, standards specify how the responsibilities must be carried out. They impose standards of conduct on the board and individual director board members.

Liabilities: These are consequences when directors fail to carry out required responsibilities with the required standards of conduct. Liability may be imposed on the cooperative or individual members of the board.

boards of directors. Of course, each of the responsibilities will be carried out differently depending on the cooperative, but fundamentally the circle of seven responsibilities describes all cooperative boards of directors.

1. Board represents cooperative members

Cooperatives are created and operated to serve members’ needs. Members invest in the cooperative, they patronize it and they exercise ultimate control of the cooperative. The board of directors is the means by which the needs and desires of individual cooperative members are incorporated into the cooperative. In some circumstances, of course, members vote directly on a cooperative issue. But for the most part, members are represented by the board of directors.

Directors are elected by members and directors’ role is to represent those members. To represent members effectively, directors must know what members need. They also assess the cooperative’s capabilities to meet those needs. Directors must understand the strengths and weaknesses of the cooperative and make judgments based on a

either case, the cooperative cannot be successful and disaster is likely to follow.

3. Board hires and supervises management

Directors do not run the cooperative themselves. Employees are used to do the work necessary, given policies the board has established about the purpos-

Boards of directors and management often struggle with the division of duties, supervision, and operational detail between the board and management. This issue can be detrimental to the cooperative if conflicts are not resolved satisfactorily.

es of the cooperative and specific policies guiding cooperative operations. The board hires and supervises management. Normally, direct involvement by board members is limited to only top management, but the board’s responsibility does not end with the employment of a chief executive officer. Supervisory responsibilities vary according to structure and circumstances.

4. Board is responsible for acquisition and preservation of cooperative assets

Cooperatives acquire and use assets

This may be one of the most misunderstood and neglected of directors' responsibilities. In most situations, it does not require specific action on the part of the board, but only if the proper safeguards have been established and are in place for all to see. A periodic review of the cooperative along with established policies and rules requiring operation on a cooperative basis are essential. But nothing gives the cooperative as much protection as an articulated dedication to cooperative principles understood by the board, the members, and management.

ciates that a wide range of operating methods and structures is available to cooperatives. Preserving cooperative principles doesn't mean that the cooperative is either small or simple. It only means that the fundamental character of the organization is that of a cooperative regardless of size or complexity.

allowed to deviate from principles to the extent that it is no longer a cooperative, the directors have failed in this responsibility. This can be a breach of the trust that members have placed in the board, and in some cases it can be a violation of law.

The responsibility imposed on the board to preserve the cooperative character of the organization means that the directors must know what that character is, how it operates in the structure of their organization, and what kinds of events and actions may undermine cooperative fundamentals.

Implementing exercise

At your next board meeting, consider conducting a complete assessment of sources of the board's authority, including statutory requirements, bylaw provisions, policies, board structures or another source of board authority.

- *What is the source of the authority?*
- *What does it mean for the everyday operation of the board?*
- *Does the board fully appreciate its authority—and its limits?*
- *How can the board respond better to the authority it is assigned?*

At each of the subsequent seven board meetings, thoroughly consider one of the responsibilities listed.

- *What specifically does the board currently do to meet the responsibility?*
- *What are the weaknesses in the board regarding its responsibility?*
- *Does each director have the skill, interest, and time to consider and respond to the responsibility?*
- *Does the board have the knowledge and information necessary to meet each responsibility?*
- *What specific steps can be taken to make the board meet every responsibility?*
- *Is there a consensus on the board's performance?*
- *Would members agree with the board's self-assessment?*

The most effective way to make the responsibilities "up close and personal" is to have each director individually address the issue and propose his or her own solution to problems perceived about the responsibility under discussion. Board meetings or ancillary sessions to board meetings can then provide the forum for discussion within the board. These sessions may be more effective if management is not present.

6. Board assesses the cooperative's performance

Every organization evaluates its performance to assess the policies and actions taken during the year and to plan effectively for the future. For cooperatives, performance rules are not identical to those that generally apply to other types of businesses, although they are deceptively similar. A cooperative is indeed concerned with the "bottom line" and its success as measured by financial criteria, but it is not organized to simply benefit itself. The cooperative's performance is ultimately measured by the benefit it confers on those who use it. Performance is judged by the cooperative's fundamental objectives.

This may be accomplished in differing ways, as no single standard of measure is available to the board. The board is faced with multiple criteria, and some may be conflicting. Some criteria may be measured in numbers, and some cannot be measured by any financial documents. Despite the variations, the board must keep its eye on the cooperative's ultimate goals, make careful assessments of performance and strategies, establish appropriate policies, and make hard decisions on behalf of the members.

7. Board informs members

Cooperative boards of directors inform members about the cooperative organization—the members' own business. This duty is rather unique among businesses in its importance and implications for member control.

Without accurate information, members cannot make decisions about their cooperative and will not be prepared to make decisions imposed on them as cooperative members. Members will not be able to understand whether their cooperative is successful, or whether basic changes must be made to correct problems identified by the board. And without accurate and complete information, members will not be able to make judgments about cooperative management or about the board's own performance.

Member information completes the directors' "circle of responsibility" leading to member representation. ■



Co-op directors held to high standards

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Editor's note: In the last issue we examined the circle of seven responsibilities that all directors have. This second article in a series of three discusses standards of conduct applied to directors and the sources of legal liability imposed on directors when they don't meet the standards. It concludes with a discussion of protections for individual directors against personal liability. Just as responsibilities can be divided into seven distinct, yet related, items, standards of conduct, liabilities and responses can be viewed in seven steps.

1. Directors' roles in perspective

A number of responsibilities are imposed on a cooperative board of directors, but where do individual directors fit in? Four perspectives of directors' roles help identify board and individual director responsibilities. Starting with the broadest perspective and narrowing the view to the individual director gives the following breakdown.

The cooperative is a business organization, almost always a corporation. All of the substantial rules governing cooperative directors come from corporate law.

The cooperative is a very special kind of corporation. Cooperatives operate according to appropriate cooperative rules or principles. These unique cooperative attributes define cooperatives' unique objectives, they require specialized income distribution and

The Circle of Seven Responsibilities

(As described in the previous article in this series, see July–August 2002 issue, page 30.)

Directors:

1. Represent members
2. Establish cooperative policies
3. Hire and supervise management
4. Oversee acquisition and preservation of cooperative assets
5. Preserve the cooperative character of the organization
6. Assess the cooperative's performance
7. Inform members

financing techniques, they impose unusual decisions on the board of directors and they give cooperative directors "something else to think about."

Narrowing the perspective further, the board of directors acts as a body. The power to act on behalf of the cooperative is given to the board of directors as a body, not to individual directors. No special power is given to an individual board member to act officially. As an individual, a board member has no greater authority than an ordinary cooperative member. The board derives its authority from the incorporation statutes, articles of incorporation, bylaws, and the members. These all identify the board of directors as the governing body.

This perspective further defines an

individual director's participation in the cooperative. Decisions are board of director decisions, so an individual director must be able to work effectively within the dynamics of the board to influence board decisions. The board as a whole will be effective only if procedures, committee structures and interaction is conducive to good decision-making. If a director objects to a decision, it is imperative that a negative vote be recorded, otherwise the director will be held to have agreed with the decision.

Responsibilities, standards of conduct and possible liabilities fall on board members as individuals. If the standards of conduct are not met, individual directors may be liable to shareholders and members, to the cooperative, to creditors, to patrons and to the public through civil or criminal laws. What are the standards of conduct by which directors are measured?

2. Standards of conduct

Standards of conduct for corporate directors have been developed over many years by judicial decisions and legislative action. Although cooperative directors face numerous special problems, no separate set of standards has ever been developed for cooperative directors. Therefore, corporate rules generally apply to cooperative directors.

Standards applicable to cooperative directors (as is the case with corporate directors) are usually divided into three "duties." These are summaries of many decisions and statutes and are stated in general terms in this article. The three duties are "duty of obedience," "duty of care" and "duty of loyalty."

3. Duty of obedience

The term “duty of obedience” sounds odd but is logical when explained. The duty means first that directors must perform their roles in conformity with the statutes and terms of the cooperative’s documented requirements for the directors. The authority given to the board of directors is defined, as is the purpose of the cooperative. Acts beyond those limits are “ultra vires” and are not authorized.

Neither may the board make decisions that are either themselves illegal or that will cause the cooperative to do something illegal. The duty of obedience also implies that the board should mandate necessary records and record-keeping, internal procedures, policies and compliance programs, then supervise the process to the extent necessary to protect the cooperative from illegal or improper actions.

4. Duty of care

The duty of care, also called the duty of diligence, has developed in judicial decisions but is also found in many corporate statutes. Statutes typically describe the duty of care in three parts: good faith, prudence and judgment.

Directors are required to act in good faith in all circumstances. Directors must also exercise care that an ordinary person in a like position would in similar situations. Finally, a director must make decisions for the cooperative in a manner that he or she reasonably believes to be in the best interests of the cooperative. Directors

have the highest obligation to the cooperative and stand in a relationship of trust—a fiduciary relationship. Good faith, conscientious care and best judgments are expected of each and every director.

Diligence and care raise two particular challenges for cooperative directors. Directors may fail in their duty if the board does not adequately supervise management. The board must devise some way to be sure that management and employees conduct themselves in the cooperative’s affairs in an ethical and legal manner. The board also establishes the cooperative’s strategic direction and evaluates management’s progress toward the cooperative’s goals. In addition to selecting top management (usually the manager or CEO), the board’s duty of diligence requires that the board evaluate management’s performance, establish succession plans and, if necessary, dismiss top management.

Often, questions about a director’s performance revolve around what the director knows. Generally, ignorance does not excuse a director from liability. Directors must know what they are doing or they cannot satisfy their duty of care.

The knowledge requirement is usually divided into two important parts. Directors will be held accountable for *what they know* and *what they should know*. A director who is actually ignorant of a fact is not excused if the law requires that the fact *should have been known* by the director.

How is a director to gain this knowledge? Directors are sometimes said to have a duty to inquire about facts which are required for them to carry out all of their responsibilities. Directors have a right to inspect all books and records. They have the additional duty to

understand the financial condition of the cooperative and its business operations. Directors are presumed to know what is in the cooperative’s books and records. As a general statement, directors will be charged with knowledge of *what it is their duty to know*.

5. Duty of loyalty

Loyalty is perhaps the most troublesome area of liability in corporate law, including cooperative law. It is troublesome because it is not well understood, and the presence of disloyalty or conflicts of interest is devastating to a director’s personal position of trust in the cooperative. As has been mentioned, directors occupy a position of highest trust and confidence upon which the cooperative and the entire membership relies. That position must be protected in any action taken and in any decisions made.

Several kinds of behavior are prohibited by the duty of loyalty. Self-dealing, where the director makes a special prof-

Conflicts of interest

Conflicts of interest involving directors are unavoidable and can have serious consequences if not handled properly by the board and the cooperative. This topic will be further examined in the third part of this series.

it by doing business with the cooperative, is a breach of the duty of loyalty.

As discussed in the previous article, directors of cooperatives are placed almost automatically in a position of dealing with the cooperative. This is not a problem if handled properly. In fact, a common statutory provision describes permissible situations. A typical provision states “No director, during the term of his office, shall be a party to a contract for profit with the association differing in any way from the business relations accorded a regular member or holders of common stock of the association or others, or differing from terms generally current in that district.” Conflicts of interest situations always pose special challenges.

Do corporate statutes apply to cooperative directors?

Generally yes, for two reasons. Cooperative incorporation statutes usually state that corporate law applies to cooperatives unless corporate law conflicts. Cooperatives are incorporated bodies that have all of the basic characteristics of corporations; directors’ roles, duties and responsibilities are no exception.

The duty of loyalty imposes other restrictions on directors. A director will violate the duty of loyalty by dealing with someone directly who could have otherwise dealt with the cooperative. This is called “appropriating the cooperative’s opportunity.” Loyalty also requires the highest degree of honesty and fair dealing with the cooperative and on the cooperative’s behalf.

Directors are often in a position where they could violate the final aspect of the duty of loyalty: that of confidentiality. Directors are privy to information about the cooperative that may not be public. This is particularly the case where directors have access to information about the affairs of other members of the cooperative. Directors are under strict prohibitions about either divulging confidential information to anyone else or using it for their own benefit regardless of the harm to the cooperative.

Generally, a violation of the duty of loyalty, typically in situations referred to as conflicts of interest, is the quickest and surest way to make a director liable for wrongdoing.

6. The business judgment rule

Directors constantly exercise judgment on behalf of the cooperative, and sometimes that judgment does not lead to the best outcomes for the cooperative. Unexpected events can turn a good plan bad. Or directors may simply make a mistake in judgment. What happens when directors’ actions lead to losses or other detriment to the cooperative?

Normally, courts will not interfere with the internal operations of a business to replace the judgments of the directors with the court’s own judgment on business matters after the fact. The *business judgment rule* says that, absent fraud or self-dealing, business judgments made by directors will not be overturned by the courts and will not lead to director liability. Directors do not and cannot guarantee the success of the cooperative or each decision made.

Courts have generally given three reasons for the business judgment rule.

Implementing exercise

Establish a schedule to consider—at board meetings or ancillary meetings—each of the standards of conduct imposed on directors. Systematically consider each standard and its requirements. At each meeting, thoroughly examine one of the standards outlined in this article.

- What specifically does the board currently do to meet the standard?
- What are board’s weaknesses regarding the standard?
- Does each director have the skill, interest and time to consider and respond to the standard’s requirements?
- Does the board have the knowledge and information necessary to meet the standards?
- What specific steps can be taken to make the board meet every standard?
- Is there consensus on the board’s performance?
- Would members agree with the board’s self-assessment?

Even more than the board’s responsibilities, the standards are personal to each director. Each director should individually address the issue and propose his or her own solution to problems perceived about the standard of conduct under discussion. These sessions may be more effective if management is not present.

The board should also consider the mechanisms the cooperative has in place to protect directors, such as indemnification provisions and D & O insurance. Assessment of state law applicable to the cooperative and directors will be part of the analysis.

Few members would be willing to serve as cooperative directors if they faced personal liability for good faith errors in judgments that results in harm to the cooperative. Courts also recognize that courts themselves are ill-equipped to make business judgments for directors and that second-guessing board decisions is not an efficient way to monitor directors. Finally, a cooperative cannot be managed efficiently if directors are not given wide latitude in law to handle the cooperative’s affairs.

It is important to understand the limits of the business judgment rule. Courts usually say that the authority of directors is absolute when they act within the law, and questions of policy and internal management are—in the absence of non-feasance, misfeasance or malfeasance—left wholly to their discretion. The rule is not a protection if the offending action was an abuse of the board’s discretion, was tainted with board member conflicts of interest or was a result of the directors’ abdication of their duties to the cooperative. Courts will step in and hold directors liable for their actions when direc-

tors are guilty of willful abuse of their discretionary powers, or bad faith, or of neglected duty, or of perversion of the purposes of the corporation, or when fraud or breach of trust is involved. Otherwise, directors are not personally liable for mistakes while exercising their informed, best judgment.

7. Minimizing risk

An easy but inadequate suggestion for avoiding problems as a cooperative director is to understand and appreciate the responsibilities listed in the first article in this series, know and adhere to all standards of conduct in this article and make no mistakes that may be detrimental to the cooperative. The first two suggestions are in the control of each director and are, in fact, the best defenses to legal challenges to director performance.

Protection is best when a proactive attitude is adopted by each director to know the responsibilities and standards, understand what it means for the director’s performance and identify particularly sensitive issues in the cooperative, for the board of directors and regarding

the director's own personal performance.

Directors may also give attention to several other actions and practices that are beneficial to their performance. Board structure, proper use of committees, effective board discussions and leadership, flows of information from management to the board and good board-management relations can avoid a number of problems. Directors may rely on experts, advisors, employees, and board committees, within certain limits. Reliance does not relieve directors of their responsibilities but does show care and diligence.

Reliance on others must, of course, be justified and cannot amount to abdication of responsibilities and duties. Director training is key to effective directorship. Effective training programs must go far beyond indoctrination by management about the cooperative's business from management's viewpoint.

Compliance programs can be helpful, and in some cases are necessary, to implement directors duties of care and management monitoring. Compliance programs are formalized internal programs to monitor certain types of behavior to be sure neither the cooperative nor employees violate some law or fail to take a required action. These programs are typically designed around legal requirements such as environmental issues, antitrust and securities laws, financing issues, or special problems that may be sensitive for a particular cooperative. To be effective, the board must insist on workable programs, must monitor their implementation and insist on full support by management at all levels. In some cases, a poor compliance program is more likely to cause problems than no program at all.

Legal audits are another technique directors may use to assist them in their duties. A legal audit can include review of the cooperative's legal structure and documents that govern the cooperative internally as well as its relationships with members and others, analysis of assets and liabilities, evaluation of potential claims against the cooperative, a thorough examina-

tion of procedures in place and recommendations for changes needed to address weaknesses.

Whatever action is taken, the overall attitude of directors should be active, positive, creative and dynamic. The great responsibilities imposed on cooperative directors and the associated potential for liability should not lead to a defensive posture.

Indemnification

Legal challenges to cooperative directors and litigation involving directors cannot always be avoided. The trauma of such actions against directors is significant. In one regard, the burdens can be relieved somewhat in most circumstances.

Legislation has been used in many states to allow a corporation (and presumably a cooperative) to indemnify directors who are subject to legal action that requires expenditures of sometimes substantial sums in defense. Indemnification in this context simply means that the cooperative pays for costs incurred by a director who is responding to legal actions for some act as a director.

In addition to authorizing indemnification and describing procedures for indemnification, statutes usually establish standards of conduct permitting indemnification. A cooperative may not be permitted to indemnify a director where the director's conduct in question fails to meet certain standards of conduct. For example, directors who cause harm to the cooperative by self-dealing or fraud against the cooperative cannot demand indemnification when they are sued for such actions. When contemplating indemnification, a board considers not only the applicable statutory requirements and restrictions, but also determines under what circumstances the cooperative should or should not indemnify a director.

Insurance

Cooperatives can purchase insurance to protect the cooperative and its directors in case costs are incurred defending litigation against directors. Usually

called D & O insurance because it covers both directors and officers, the insurance is often in the form of two policies. One covers directors to the extent the cooperative does not fully indemnify them for their costs. The other covers the cooperative itself for the indemnification made to directors.

As with nearly any insurance arrangement, each policy will be tailored to the needs of the cooperative. Terms will be negotiated that include: level of coverage, exclusions, claims or occurrences methods, deductibles and general claims procedures. ■



Cooperative directors face unique challenges

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Editor's Note: *This is the third of three articles dealing with issues facing cooperative directors. The first installment appeared on page 30 of the July-August 2002 issue while part two was on page 15 of the September-October 2002 issue. These and other past issues of this magazine can be assessed via the Internet at: <http://www.rurdev.usda.gov/rbs/pub/openmag.htm>*

Cooperative directors regularly face problems that directors of even the largest and most complex corporations need not even think about. The tough issues don't depend entirely on cooperative size

The Circle of Seven Responsibilities

(As described in the previous article in this series, see September-October 2002 issue, page 15.)

Directors:

1. Represent members
2. Establish cooperative policies
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5. Preserve the cooperative character of the organization
6. Assess the cooperative's performance
7. Inform members

either. Directors of small cooperatives face many decisions as difficult as any confronted by the largest cooperatives.

Special cooperative director challenges require personal wisdom and good collective decision-making abilities. In some ways, cooperative directors need to know more—and think about issues more carefully—than directors of other kinds of businesses. Cooperative boards certainly demand more time and work. In addition, the dual role of a director in a cooperative—as both a director and a member—puts every director in a sensitive position.

This article, the last in a series about cooperative directors, identifies some unique issues that cooperative directors must consider on a regular basis. It focuses on issues that are “in addition to” the responsibilities expected of directors of all businesses.

The character of the cooperative

Cooperatives are unique kinds of businesses. Members justifiably expect their cooperative to operate on a cooperative basis with the appropriate mix of rights and obligations for everyone. Members trust the board to fully support those expectations.

Sometimes cooperative characteristics are defined by law. In other situations they are just an inherent part of the cooperative that members understand and expect. In any case, directors have the ultimate responsibility to preserve the cooperative character of the organization.

This responsibility presents some

Cooperative directors are responsible for maintaining the cooperative character of the organization.

hard questions for the board. Is the organization truly operating on a cooperative basis? How do directors know it is? What observable criteria can be established to guarantee the integrity of a cooperative's implied promise to be a cooperative? Are measures taken—either on a periodic basis or in preparation for significant business changes—to be sure that basic cooperative principles are preserved? Has the board established policies, operating procedures and internal controls to guarantee operation as a cooperative? Does the cooperative have danger points in its operations that require special monitoring and attention?

Although difficult, the directors' role in maintaining the ability of the cooperative to serve members in a uniquely beneficial manner can be a rewarding professional and personal experience for directors. Each director is a gatekeeper of the principles and practices that empower members to cooperate to create true value for themselves and others.

Cooperative-based decisions

Cooperative boards of directors make decisions not made by boards of any other kinds of business. These decisions are, for the most part, unusually difficult. They require directors to have a clear understanding of financial documents, performance measures and the short- and long-term consequences

of decisions made and actions taken. Situations may make the board a conflict-resolution body that balances divergent and often deeply held interests among members. Some of these involve business and financial issues, while others are emotional in nature.

Operating within proper authority was mentioned in a previous article. The cooperative's authority and limitations on that authority may be found in several places. The board's authority may be defined by the cooperative's charter, including the applicable incorporation statute. The board of a cooperative

tee that the cooperative adheres to laws and other legal obligations. Directors may, of course, rely on counsel and accountants to identify the rules, but directors themselves make the decisions and bear the responsibility for decisions made.

Determining and allocating patronage refunds is one of a cooperative board's major concerns. Of course, the board does not make decisions about refunds on the spur of the moment each year. The system used to determine and calculate refunds should have been established in the bylaws and in written

policies, all of which are subjects of careful director study and periodic review. Decisions about allocations and distributions are complicated by short-term and long-term implications as well as balances among those who use the cooperative for different purposes. All this leads to possible conflicts among

tors should recognize the importance of keeping good membership roles and purging those who no longer deal with the cooperative. The behavior of some members may harm the cooperative and therefore other members. Directors have the unenviable task of taking appropriate action to protect the cooperative. Predetermined, neutral rules that avoid ad hoc decisions about individual members will help avoid confusion and hard feelings.

Decisions with federal income tax consequences are pervasive. Directors are not expected to be tax experts, but they do need to appreciate the implications of all of their decisions. Examples of decisions with direct tax implications include use of qualified or nonqualified notices of allocation, per-unit retains, allocation of margins and losses and most issues regarding calculating margins and distributions.

Patron or non-patronage business and the allocations and payment of related net margins have direct income tax implications. Added to the direct effect on the cooperative is the impact that any such decisions have on members or other patrons. A seemingly simple business decision by cooperative directors becomes one of balancing many interests.

Conflict of interest

Like other members, directors use the services of the cooperative. This means that directors deal personally with the cooperative. They have their own obligations toward the cooperative and their own expectations of benefits from it. Decisions that directors make about the cooperative will affect them as member-users just as they affect the cooperative and other members.

The previous discussion of "duty of loyalty" pointed out that the single action most likely to impose personal liability on a director is a conflict of interest. The personal dealings that a director has with the cooperative places the director in a precarious position. What appears to be innocent when done may in hindsight look very bad for the director.

Many examples exist of directors' dealings with the cooperative that will

Cooperative principles should be familiar to every cooperative director.

1. The User-Owner Principle: The people who own and finance the cooperative are those who use the cooperative.
2. The User-Control Principle: The people who control the cooperative are those who use the cooperative.
3. The User-Benefits Principle: The cooperative's sole purpose is to provide the distribute benefits to its users on the basis of their use.

considers incorporation statutes, the articles of incorporation and bylaws to determine the obligations and limitations of the cooperative.

Laws that apply generally to all businesses apply to cooperatives as well, but sometimes in a different manner. Such laws mean that cooperative boards must make decisions for the cooperative based not only on generally applicable laws, but laws that are especially applicable to cooperatives. Examples include special tax laws that apply to cooperatives, cooperative antitrust laws that mandate or prohibit certain business structures and behavior, and state cooperative incorporation statutes that contain special requirements for cooperatives.

A cooperative's charter, its bylaws, its contracts, membership agreements and other binding agreements are all subject to review by directors as they establish policies and procedures to guaran-

tee cooperative members.

The cooperative may also face circumstances that weren't contemplated when the policies were established. The board must decide what modifications can be made in response to special circumstances to recognize the cooperative's purposes.

Any patronage refund system has many implications for the cooperative and its members. These include fairness, operation on a true cooperative basis, tax implications, rules in state laws, interpretations of bylaws, members' expectations and desires, and the very health and survival of the cooperative. Successful solutions to sensitive issues ultimately rest in the hands of an informed, deliberative board of directors.

Member qualification is important to a cooperative, whether the qualifications of applicants for new membership are at issue or continued qualification of existing members is in question. Direc-

affect both the director and the cooperative and pose possible conflicts of interest. These include:

- Price differentials or special concessions for large producers and patrons.
- Directorship in both a local cooperative and the federated cooperative.
- Extension of credit to member-patrons.
- Methods of obtaining capital.
- Allocation of patronage refunds, especially when the cooperative is a multi-functional cooperative and the functions are not totally separated.
- Cash or non-cash patronage refunds related to patron tax brackets.
- Equity redemption decisions, including when to redeem, financing methods and equity-building programs.

Directors must make these and all other decisions regardless of the shared interests of directors and the cooperative. Cooperative incorporation statutes recognize the problem, at least with respect to the patronage relationship. A

typical provision says that “no director, during his term of office, shall be party to a contract for profit with the association differing in any way from the business relations accorded regular mem-

bers or holders of common stock of the association or others, or differing from terms generally current in that district.” Directors should not have problems if the conflict is clearly recognized, decisions are made solely with the interests of the cooperative foremost and all questions are addressed openly and honestly.

Financial matters

Directors must give careful attention to the effective financial structure and strong financial condition of the cooperative. Directors are entrusted with the ultimate responsibility for the care of the funds and property of the cooperative and its members. Although similar general rules apply to non-cooperative corporations, a cooperative’s directors handle unusual issues because cooperatives have special techniques to finance the organization. Because cooperatives operate for the mutual benefit of the members and not as purely profit-seeking organizations, they have financial needs, opportunities and limitations not found in other businesses. Ultimately, the most difficult financial decisions are in the directors’ hands.

Patronage refund distributions are closely related to equity allocations in most cooperatives.

Directors are involved in the balance between current monetary returns to members and additions to the cooperative’s equity structure. For example, patronage refunds may be paid in a combination of cash and written notices of allocations. The choice carries major implications for the long-term financial health of the cooperative. At the same time, members may expect

high cash payout as a return for their involvement in the cooperative and their own tax considerations. Allocations and choices of the income to allocate, equity vs. debt financing and

patronage-based vs. non-patronage-based sources of financing, are all part of plans and strategies that boards of directors establish.

Equity redemption is an integral part of a cooperative financing system. It can also be a source of dispute. Decisions about equity redemption are often assigned specifically to the board’s discretion. How is the board of directors to exercise that discretion? Do short revolving periods jeopardize the cooperative’s financial health and robustness? Do long revolving periods show poor planning, do cooperatives use former members’ money to generate benefits for the current users, and does slow revolvment present fairness issues? Courts usually support director decisions on equity redemption in a legal dispute, but the major challenge for a board is to meet obligations of past, present and future members with fairness and forthrightness to avoid unresolvable problems.

Special events

Directors bear added responsibilities when the cooperative considers a major change in its organization or in its relationships with other businesses. Mergers or establishing long-term, significant joint-venture arrangements with other businesses are examples of events where directors have a major responsibility for decisions that are of critical importance to the cooperative. Such events affect members’ interests in the short run and in the long run.

Decisions affect benefits that all parties involved will receive, including financial obligations (past and future), differential impacts among members and planning horizons for all parties. Directors not only assess overall costs and benefits of such actions, they will be required to address conflicts among members about the action.

A decision to dissolve a cooperative is, of course, among the most difficult the board will make. The process not only occurs under typically unpleasant circumstances; it challenges the abilities and dedication of all involved.

Directors will be well served by making every effort to recognize how

Standards of conduct applicable to cooperative directors include:

1. Duty of Obedience. Directors must ensure that they or the cooperative do not engage in illegal or improper actions.
2. Duty of Care. Directors are expected to act in good faith at all times, exercise prudence, and apply their best judgments for the benefit of the cooperative.
3. Duty of Loyalty. Directors have a position of highest trust and must avoid conflicts of interest, self-dealing, act in any other than the best interests of the cooperative or divulging confidential information.

typical provision says that “no director, during his term of office, shall be party to a contract for profit with the association differing in any way from the business relations accorded regular mem-

standards of conduct discussed in previous articles in this series can guide them. Adequate information about the implications of the action, the mechanics of the process, impacts on members and the future of the cooperative are all critically important. Balancing member interests and measuring the financial and other needs of the cooperative will guide directors' decisions.

Assessing the cooperative's success

Important decisions about the performance of management, success or failure of strategic plans or specific programs, and designing plans for the future are all based on an accurate and realistic assessment of the cooperative's current performance. Such an assessment is not necessarily easy under any circumstances.

As with any business, the "bottom line" is critical. But unlike other businesses, for cooperatives the bottom line is only the beginning of an assessment of its true success. Every director needs to understand financial statements, organizational growth, project plans, overall strategies and levels of service offered. But more is required.

Difficult questions require additional board consideration. What was the net benefit of an action to members, including their share of savings and margins? What was the tradeoff between benefits distributed to members and the net income of the cooperative? What is the financial condition of the cooperative and what are the trends and expectations for future capital needs?

Were all members treated equitably in distributions and financing obligations? Did the cooperative serve some members at the expense of greater returns to others? If so, is that practice part of the cooperative's greater purpose? What was the trade-off between short-run and long-run needs, obligations and benefits? Are successes or failures attributable to management, board decisions, the economic environment or member actions? What can or cannot be corrected about the cooperative's performance?

Directors balance members' interests

The cooperative's fortunes are those of its members, and if the cooperative is not responsive to members' needs, the basic principles of member control and user benefit are weakened. The cooperative will simply cease to exist and serve.

The membership of most cooperatives is not homogeneous. Each member has an interest in the cooperative. These interests differ to some degree, sometimes dramatically from other members. Members may have differing planning horizons, as would be the case between someone just starting in the farming business and someone contem-



To be effective, board members must have a solid grasp on co-op financial statements. Request to meet with the co-op manager or accountant if you need more background on how to read them.
USDA Photo by Ken Hammond

plating imminent retirement. These two members could have markedly different interests in financing, revolving periods for patronage payments and cash vs. non-cash payments. Members may be in different tax brackets, which has implications for the amount and form of patronage refunds.

Some members may be more concerned with price while others may find certainty of supply or a market more important. Producers of different products may have distinctly different needs from the same cooperative. Disparity of business volume among members may lead to calls for differential pricing. These and other variables make the directors responsibility to represent members quite different from decisions for non-cooperative businesses.

Members, or prospective members, may want more from the cooperative

than the organization can provide and still maintain its financial and operational integrity. Directors may actually be put in a position of balancing some members' needs against the interests of the cooperative itself. Diplomacy and good communication are valuable, but no easy resolution may be possible.

Board-management relations

A good working relationship between the board of directors and management is very important for cooperatives. At the same time, the relative responsibilities of the board and management create natural tensions about roles and responsibilities.

The cooperative board has a distinct role and make-up that places obligations of independence and leadership on the cooperative board of directors that are not necessarily found in other boards.

Does the board defer excessively to a forceful manager? If so, what might the consequences be? Does the board interfere inappropriately in the cooperative's management and day-to-day operations? If so, what are the consequences? How does the board assess management and what corrective measures are in place in case of difficulties? Is there an effective chain of communication and command between the board and management? What does management think of the board of directors? If necessary for the good of the cooperative, is the board of directors capable of making and executing a decision to replace management?

The rewards

With all of the responsibilities placed on boards of directors outlined in the first article in this series, the high standards of conduct required of individual directors discussed in the second article and the many difficult decisions directors make as noted in this article, why would anyone agree to be a cooperative director? Individuals can point to at least five reasons to serve as a cooperative director.

The rules that apply to responsibilities, liabilities, duties and requirements

are pretty clear. With diligence and care, a cooperative director has guidance to avoid the many pitfalls suggested by a cautious view of a director's job. Though a director may face unpleasant, and sometimes unexpected circumstances, adherence to high personal standards of conduct is excellent insurance against personal problems.

Directors are part of a team. This team is not only a source of support, it is a reward in itself. Difficult issues are discussed within the board before decisions are made; information is generated and shared, and decisions are made as a board. Responsibilities are shared with others in a similar position. The team concept includes not only the board of directors, but management and, most importantly, the cooperative's members. The opportunity to take an active role in multiple constituencies is unusually valuable for a cooperative director.

The sheer challenge of being a cooperative director can be added as a third source of reward. Directors see a problem from its discovery. They define the issues it raises for the cooperative and members, identify the range of possible solutions, gather and study the information needed to assess the solutions, determine what the consequences of various courses of action might be, make a decision, create the policies and directives needed to implement the chosen solution, and assess the consequences of the board's decisions. The more difficult the problem, the greater the rewards of finding an answer. The more critical the issue is to the success of the cooperative, the more satisfying is the problem-solving process.

Directorship presents an opportunity to serve others in direct and important ways. Beneficiaries of a successfully guided cooperative include members and patrons, the cooperative's management and employees, the individuals and businesses that deal with the cooperative, the communities in which the cooperative and its members and employees are located, and the marketing and supply systems in

Implementing exercise

As a board, review the character of your cooperative:

- What is the stated purpose of the cooperative?
- What does this mean when balancing interests?
- Identify the "stakeholders"—those who have an interest in what the cooperative does and how the cooperative performs.
- Identify the principle things that make the organization a cooperative and distinguish it from other kinds of businesses.

Revisit the cooperative's vision statement, mission statement and objectives.

- Are they adequate, realistic and up-to-date?
- Did they come from the membership or were they devised as a board-management exercise?
- Are members familiar with their cooperative's vision, mission and purposes?
- What do the members think of them?

Set aside some time at a board meeting (after preparation) to discuss what measure of success the board should use to assess the cooperative's performance, its management, and the board of directors.

- Start with the broadest list and set priorities.
- Are some measures incompatible with others?
- If trade-offs are required, what decision rules can be devised?
- What would members think of the trade-offs and decision rules?

Make it personal—it already is!

- Identify the issues that you personally find to be the most uncomfortable, those you'd really rather not have to make decisions about.
- Make a plan to share the burdens of the decision.
- List the factors you will consider in addressing the problem.
- Do you think others share your discomfort?

which the cooperative operates. Individuals considering being a director should consider the significant impacts they can have beyond the boardroom and even on the cooperative.

Finally, board membership carries personal prestige despite the many duties and difficulties. Serving on a cooperative's board of directors is a worthy personal and professional goal. Directorship should be a source of great personal pride and satisfaction. ■

