

Precautions and Protections

Summarizing legal responsibilities of cooperative boards

BY THANE JOYAL AND DAVE SWANSON



As cooperative directors, it's important that we know our jobs. Some parts of that job are personal to us: we bring interests, skills, and perspectives that make our contributions unique. It's our responsibility to use those personal attributes to participate constructively in the group that makes up the cooperative board. A key way to do this is to follow the rules that have been established by the group itself. Another key way is the subject of this article: to be effective directors, we must comply with the legal requirements that apply to us.

The good news is that the law is understandable.

Although liability risk is present, common sense does have value, and there are tools to protect directors. As long as we bring our best attention and care and loyalty to our job as directors, keep good records of the board's proceedings, and follow a few other good practices, the chances are high that the law will find we have fulfilled our responsibilities.

What legal requirements apply?

The primary sources of law that govern the responsibilities of cooperative directors are:

1. state incorporation statutes; and
2. court-established common law, which is an artifact of our legal system's English heritage.

These responsibilities are commonly called a director's "fiduciary duties." The duties vary from state to

state, but there are common principles and themes.

A cooperative is a corporation created in accordance with the laws of the state chosen for its creation. Almost all the state cooperative and corporation laws (and most co-op bylaws) mandate the formation of a board of directors, which generally has very broad authority for governing the cooperative on behalf of its owners.

The members' authority is typically limited to major decisions, including election of directors, changes in bylaws, and liquidation or sale of the cooperative. The board can be thought of as the brain of the cooperative—it thinks and plans and decides. The state statute, then, gives rise to the basic relationship of the board to the cooperative, and many of these statutes set standards for the

board's performance.

The other source of legal duties arises from the common law, which is a body of law built on standards for director liability established by courts in cases against directors.

Fiduciary responsibility

A director is required to work for the benefit of the cooperative and all of its owners collectively. This is true even though you may have run for the board in order to represent a specific group or position within the cooperative. Once you are elected, you have a new relationship to the cooperative. Specifically, a director has a fiduciary obligation to the cooperative and its members as a whole, rather than a duty to a constituency or group of members. This is unlike a state or federal legislator, who usually represents a constituent group or set of ideals.

Thane Joyal once had an interesting argument with a board member who had lobbied in opposition to a board-generated proposal for revision of the cooperative's bylaws, with the result that the proposal failed to achieve member approval. The bylaw draft had been prepared and adopted by the board in accordance with the agreements the board had made for decision making. The board believed that these changes were needed for the cooperative to thrive. This particular board member disagreed personally with the decision the board had made, and argued that just as legislators in the U.S. House of Representatives have the right to voice dissenting views on legislation that has been adopted by House procedures, so he too retained a right he described as "free speech" to air his disagreement with the board's bylaw proposal.

This view may well be inconsistent with the nature of a director's fiduciary responsibility. In light of such a strongly held personal disagreement with the board's position, the board member may have better served his legal duties by resigning. A cooperative board is not the Legislature. Its role is to look out for the best interests of the cooperative and its members collectively, rather than the interests of a constituent group or viewpoint. In addition, directors are not given the benefit of the broad immunities and protections afforded to elected legislators.

Indeed, in taking on the responsibility of serving on a board, directors usually serve the cooperative most effectively by working in the framework established by the board and abiding by the best decisions the group can reach. To effectively serve on a board, we must be confident that the integrity of the process and the diversity of the individuals participating in it will lead to the best decisions for the cooperative. And most of the time (but not always), it is best for the cooperative for dissenting directors to avoid arguing against or undermining a board decision. We will have more to say about this later.

As a practical matter, in order to meet owner needs, it is likely that the cooperative will incur ►

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◀ indebtedness as a regular business practice. If the cooperative becomes insolvent to a substantial degree, courts hold that the duty of the directors shifts from responsibility to the cooperative and its members to responsibility to the creditors. As insolvency progresses, the exact transition point where this duty shifts is difficult to pinpoint. But for directors of a financially troubled cooperative, it is important to understand the shifting duty and get expert advice.

Legal duties made easy

There are two ways directors can breach their fiduciary responsibility and risk liability: liability for failure to act, or nonfeasance; and liability for wrongful actions, or malfeasance. There are two broad categories of fiduciary duty—the duty of care and the duty of loyalty.

The duty of loyalty focuses on the board's deliberative process. Excellent record keeping of board deliberations and the information and process used in making decisions can be essential, especially when major decisions are being made (such as whether to expand or open a new store). Without a record of the board's proceedings, it is extremely difficult for the board to defend itself if a particular decision is questioned. A good resource about minute taking is the Cooperative Board Leadership Development (CBLD) Field Guide on Minute Taking Essentials (www.cdsconsulting.coop/FG/minutes).

Duty of care: Carry out board responsibilities competently. These responsibilities include selection and oversight of the general manager (often cited as the board's most critical function), setting strategy and direction over the manager's operation of the business, and ensuring compliance with laws and ethical standards. Make sure the board focuses its attention on these responsibilities: show up to board meetings prepared; participate actively and attentively in board processes; make sure adequate information is obtained before making decisions; and, when major decisions are involved, study alternatives. You should also make sure the board adopts and adheres to appropriate policies, including policies regarding risk assessment and management, ethical behavior, fraud risk, limits on manager's authority and the like.

Duty of loyalty: Put the cooperative first, before personal or individual or constituent interests. Deal with the cooperative fairly. If you have conflicts of interest—whether personal, familial, or pecuniary (financial)—disclose them. Normally, the director with the conflict personally decides what course of action to take. This may range from disclosure with participation in the discussion and vote to participation in discussion but abstaining from the vote to removal from the discussion and vote.

Duty of care

Show up: Directors should attend all board meetings and should participate in all events that the board agrees are important. If you can't attend a



The boardroom needs to be a place where differences of opinion can be safely aired and where candid discussions can take place.

meeting, let your board leader know in advance whenever possible, otherwise get in touch as soon as you are able. You may be responsible for the decisions the board makes in your absence, so catch up as quickly as you can.

Be prepared: Before each board meeting, review all documents that will be acted on in the meeting. Many boards receive board packets in advance of the meeting, allowing directors to prepare. Work with management to make sure the information provided is useful in monitoring performance and making decisions. Set aside preparation time on your calendar—at least an hour and a half or two hours, depending on the complexity of the issues to be reviewed. Spend time as a board or as individual directors in training programs for director performance, and learn about the dynamics of your cooperative's industry.

Protect the board's process: The integrity of the board's process depends on YOU. When the board reaches a decision and speaks with one voice, be sure that your perspective has been heard by the group. If you don't understand something well enough to act on it, try hard to make sure the board gets the information you need before making decisions. The use of experts—management or independent consultants—to provide information and advice is an important and accepted way to protect directors from liability claims.

The board's calendar is often full, and it can feel uncomfortable to slow something down if you don't understand it fully or aren't prepared. Decide how important this issue is. If it is relatively routine, you may decide to abstain from the decision. But if it is an issue with significantly high consequences, *speak up*.

If you can't decide how important an issue is, consider using this SIT algorithm:

- Severity: How serious are the consequences of

this decision?

- Implications: What could this mean for the co-op?

- Trends: Has this come up before?

Often there's a person on the board who is, by profession, a lawyer or an accountant or a specialist in something that is relevant to the board's work. Knowing that person is going to give special attention to an issue can make even the most well-intentioned board member relax. Don't fall into this trap. Remember, when the board hires a professional to represent it, that is a special relationship where the board is entitled to rely on that expert's advice. Your friendly, competent fellow board member doesn't have that relationship to the co-op—she, like you, is simply a board member, bound by the same duties as you. *Do your own thinking*, and don't simply rely on your colleagues or management to tell you how to vote. In brief, all board members need to act and think independently.

Duty of loyalty

The duty of loyalty is the duty to act on behalf of the cooperative in the best interest of the cooperative and its members as a whole. To the extent that a cooperative director is a member of the cooperative who shares in the benefits of a successful business, of course, the director will benefit from good governance and good management. But the director should not receive preferential treatment that is better than any other member of the cooperative. And in addition, the director must protect the cooperative's confidential information.

Disclose conflicts: It is not uncommon for a director of a food cooperative to have more than one relationship to the co-op. A board member may be a farmer/vendor, for example, or may be a store employee. Or a director may be closely related to someone who is. A conflict does not have to interfere with a director's effectiveness, and it will not interfere with the integrity of the board's decisions if it is handled appropriately.

Any potential conflict should be disclosed. It is the board's process we are protecting, as well as the integrity of its decisions. It is common practice for the board member with a conflict to describe the conflict and relevant facts, answer any questions, and abstain from voting. In some cases, it is appropriate for the director to then leave the room to ensure an open discussion. For example, directors on the staff of the cooperative would be well advised to recuse themselves from decisions relating to the compensation and employment of the general manager.

Don't compete with the cooperative: What if a board member knows that the cooperative is seeking a particular business opportunity, and that board member just happens to be in a position to go after that same opportunity? Maybe the co-op's deli is bidding to cater a visiting national television crew, and a caterer on the board learns about the job from an informational report at a board meeting. Can the caterer/director pursue the contract? Absolutely

not. Business information like this is a good example of something that belongs to the cooperative and should not be used by a director for personal gain. What if the director learns of an opportunity some other way, not at a board meeting, but knows that the co-op is bidding on it? Under many circumstances it may still be inappropriate for the board member to compete with the co-op. When in doubt, seek legal advice, or avoid even the appearance of competing with the cooperative.

Don't breach confidentiality: One very important rule for board members to follow is to keep the confidences of the cooperative. In cooperatives, transparency is very important, and the duty of confidentiality may seem inconsistent with a transparency policy. In practice, however, it is a relatively small universe of information that is required to be kept confidential. Personnel information, information about unannounced expansion plans or strategies or other contractual relationships, certain legal issues, and any draft documents that have not been released to the public should be held in confidence by each board member.

This is not only a matter of board integrity. In a worst-case scenario, a board member could be held personally liable if someone—an individual or even the cooperative—was harmed by a board member's breach of confidentiality. And it is clear that the cooperative's competitive position could be harmed by the untimely release of sensitive business information.

Aside from the legal consequences of breaching confidentiality, there is another equally important consideration. The boardroom needs to be a place where differences of opinion can be safely aired and where candid discussions can take place. Once a decision has been reached and is ready to be shared with the owners and the public, a communication strategy should be agreed upon that includes how those discussions will be shared, if at all.

Most of the time, the board should speak with one voice about decisions. In important decisions, it is helpful for the board to discuss this and reach an understanding about what will be said. In some cases, however, it may be important to communicate dissenters' views to the members. An example would be a split board recommendation asking the members to approve a merger with another cooperative. In this case, it may be important to provide the members with information about the dissenters' reasons.

What if a decision is challenged?

Thankfully, one test that will not be used in the event of a legal challenge to a board's decision is whether the decision turned out to be "right" using 20-20 hindsight. Rather than reviewing whether a decision or strategy brings adverse results, a reviewing court would look at the record of the board's process to determine whether the decision was made properly at the time it was made.

It's worth knowing that there are two rules that a reviewing court may use to determine whether the decision was properly made. Until recently, it was assumed by most attorneys that a rule known as the "business judgment rule" would apply to decisions of a cooperative board.

The business judgment rule puts the burden on the person challenging a decision to show that the board's decision was not made in good faith or in the best interests of the cooperative. The focus is on the reasonableness of the board's decision-making process, not the decision itself. In other words, the board has the benefit of the doubt; it is not automatically liable for a bad decision.

A 2004 case (*Willens v. Wisconsin Avenue Cooperative Association*) involving a housing cooperative in the District of Columbia Court has cast some doubt on the assumption that the business judgment rule would apply to a case involving cooperative directors. There the court put the burden on the cooperative director to show that the board's decision (rather than its deliberative process) was reasonable. This case can likely be explained by the fact that the directors were deciding on distribution of economic benefits among the members and suggests that special care should be taken by directors in making such decisions.

Directors should be particularly careful to be deliberative when making important decisions, because these decisions are more likely to result in claims against directors and may get closer scrutiny from a reviewing court. Selection of auditors and the general manager, review of financial information, expansions or new business lines, and any sort of insider transaction should be handled with ►



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Protections

Directors of cooperative boards have the benefit of at least two special types of protection. Indemnification is typically permitted under state law if provided for in the bylaws, meaning that, under specified circumstances, the cooperative must pay the liabilities and legal expenses of a director who is subject to legal proceedings for director decisions. Obviously, if the director acts illegally the cooperative is relieved of this responsibility; depending on the state in which the cooperative is operating, there may be other circumstances where indemnification is not available. A cooperative's bylaws will typically contain a provision specifying the circumstances under which indemnification is available.

A cooperative can also purchase insurance for its directors, known as D&O (directors and officers)

Directors of cooperatives have the benefit of at least two special types of protection.

insurance. D&O policies protect the cooperative and its directors from liability for actions taken by the board. It is worth reviewing these policies and their limitations carefully to be sure that the insurance purchased is appropriate in terms of scope and amount, including deductibles. A high deductible can be particularly troublesome when directors are sued, especially if the cooperative is insolvent and cannot cover the directors' legal costs. Insurance policies often have complicated exclusions that can limit their utility in some circumstances; for example, some policies do not cover securities litigation. It's best to be well informed.

Note that these protections may not be available if a cooperative has failed to pay state or federal employment, income, or other taxes. Here the best

protection is a good system for rigorously checking to be sure these obligations are being fulfilled.

The bottom line

The topic of directors' legal duties is complex and, to a limited degree, subjective. But by following good practices and understanding the basic rules, and by obtaining professional advice, especially when major decisions are undertaken, directors can feel confident they can avoid liability. Show up, do your homework, participate fully in discussions, follow good procedures for assessing your cooperative's performance and obtaining relevant information in decision-making, carefully document (i.e., ensure good minutes are taken), honor decisions the board makes, disclose conflicts, and protect confidential information.

Simple, right? Remember, cooperative directors are working to make sure that their co-op meets the needs of the owners today, tomorrow, and years from now. Work that is done right is work that is fun. So have fun! See you at the co-op. ■

POSITION OPENINGS

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Fairbanks Community Cooperative Market

Fairbanks Community Cooperative Market of Fairbanks, Alaska, seeks a full-time professional general manager to open and operate our community-owned grocery store and deli. Position starts July 1, 2011.

Please send your resume, professional references and a cover letter to: co-opmarket@ak.net or call 907-457-1023. Job description is available at www.CoopMarket.org. The position will close at 5:00 p.m. on March 24, 2011.

General Manager

GreenStar Cooperative Market

GreenStar Cooperative Market in Ithaca, N.Y., seeks a general manager who will collaborate with and support our council in implementing our newly adopted governance model—Policy Governance, while engaging our membership, and leading staff through future growth and expansion. Our mature, financially sound cooperative (over \$14 million annual sales in two locations, more than 150 employees, and more than 7,000 members) has a strong network of local suppliers and will provide the right person with the opportunity to be at the forefront of the natural foods industry.

Our general manager should be a community builder and a good communicator, someone who shows strong leadership and is committed to building a diverse and inclusive environment. Our ideal candidate has comprehensive knowledge of the organic and local foods marketplace, excellent writing

skills, financial skills, and three to five years of related experience in a food co-op or equivalent. Competitive salary and full benefits.

Go to the GreenStar website and follow the GM application process: www.greenstar.coop. GreenStar is committed to excellence through diversity in hiring. EOE.

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- Minimum of three years' experience with natural food's supplement customer service, required.
- Certificate of completion of several natural health programs or equivalent experience, preferred.

Contact: Joe Hamilton, Pilgrim's Market, joe@pilgrimsmarket.com

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