

Duties and Responsibilities of Cooperative Board Members

By Kathryn Sedo

Members of the board of directors of a cooperative have the same duties and responsibilities as do board members of any other business. In addition, they have a few other responsibilities that are unique to cooperative board members.

Unique Duties and Responsibilities. Cooperatives are member organizations, unlike most other businesses. This places a unique responsibility on cooperative directors to be sensitive to the needs of members and balance their conflicting interests. Therefore, director decisions are based not only on what is most profitable, but also on what the needs of the members are.

One important function of the cooperative board is to educate members about their organization. Effective member control is impossible without information. It is the duty of the directors to provide the membership with that information.

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General Duties and Responsibilities. The standard of conduct required of directors of any business is found in state statutes and court decisions. A recent attempt to codify the standard was made by the American Bar Association and is named the Revised Model Business Corporation Act (Spring 1984). Chapter 8 of the Model Act is entitled "Directors and Officers." Subchapter C of Chapter 8 contains the standards of conduct that are required of the directors. That Subchapter reads in part as follows:

SECTION 8.30. GENERAL STANDARDS FOR DIRECTORS

(a) A director shall discharge his (sic) duties as a director, including his (sic) duties as a member of a committee:

- (1) in good faith;
- (2) with the care an ordinarily prudent person in a like position would exercise

under similar circumstances; and

(3) in a manner he (sic) reasonably believes to be in the best interests of the corporation.

(b) In discharging his (sic) duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(3) a committee of the board of directors of which he (sic) is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if he (sic) has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director is not liable for any action taken as a director, or any failure to take any action, if he (sic) performed the duties of his (sic) office in compliance with this section.

SECTION 8.31. DIRECTOR CONFLICT OF INTEREST

(a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction is not voidable by the corporation solely because of the director's interest in the transaction if any one of the following is true:

(1) the material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved or ratified the transaction;

(2) the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved or ratified the transaction; or

(3) the transaction was fair to the corporation.

How does a director make sure that his or her conduct complies with the standard in the Model Act or of his or her state? Three main areas can be singled out for action. If a director is attentive and diligent, loyal and acts with the care of a prudent person, then his or her actions cannot be successfully challenged. These three areas are sometimes referred to as a duty of attention or diligence, a duty of loyalty and a duty of care. Each will be discussed in turn.

Duty of Attention/Diligence. Directors must participate actively in the affairs of the cooperative. Active participation includes regular attendance at meetings, review of information and data provided by employees, experts and committees and monitoring committee and employee activities.

A director is entitled to rely on information, reports, opinions or statements, including financial statements and other data prepared by an officer, employee or committee of the cooperative when the director reasonably believes that the source of the information is reliable and competent in the area. This includes attorneys, consultants and accountants hired by the cooperative to provide information, data or opinions. In order for a director to be entitled to rely on a report, etc., the director must have read it or be at a meeting where an oral presentation was made. The general standard contained in Subsection (a) above (i.e. good faith, ordinary care and best interests) applies when judging whether reliance on a report was reasonable.

Close monitoring of employees and committee work is also required. It is important that the directors act responsibly in delegating tasks to responsible individuals. It is the responsibility of the board to make sure that any task delegated to any responsible officer, employee or committee is being properly performed.

Duty of Loyalty. Directors are in a position of trust with the cooperative and must not abuse this relationship to enrich themselves. Two main areas of trouble are self-dealing and dealing with someone who would have otherwise dealt with the cooperative.

The law with regard to self-dealing has undergone changes over the years. In the past, any type of contract between a director and the cooperative would have been subject to cancellation at any time. At the present time, if proper disclosure of all other options has been made and the contract is fair and reasonable, it is possible for a director to contract with the cooperative. Of course, the director involved should not participate in the discussion about or vote on the contract.

The question of fairness is normally determined by the range of terms that might have been entered into at arms length by disinterested persons. Therefore, if the contract or agreement is within a fair range, it will be valid.

Since directors of a cooperative are also presumably members and patrons of the cooperative, some dealing with the cooperative is inevitable. Directors should make sure that they are treated just like other members. Special discounts for directors, or special treatment of any kind, are to be avoided.

Dealing with those who might otherwise have dealt with the cooperative is sometimes called "cooperative (or corporate) opportunity." It is not appropriate for a director to deal with anyone who otherwise would have dealt with the

cooperative, thus depriving the cooperative of a business opportunity. If the cooperative, after carefully considering the opportunity, decides against pursuing it, then it is proper for a director to take advantage of the opportunity. The director who is interested in the opportunity should not participate in the discussion about or vote on the opportunity.

Part of the duty of loyalty also includes keeping confidential the affairs of the cooperative until such time as they are released to the members and the public in general.

Duty of Care. The duty of care that is required of directors is found in Section 8.30(a) of the Model Act (which is set forth fully above). A person must act in good faith. A director has to act in the best interests of the cooperative. In so doing, the director must act as a prudent person would under similar circumstances. This standard allows for the taking of risks as long as they are reasonable under the circumstances. A director does not guarantee the result of his or her decision, but that it was arrived at honestly and prudently.

Hindsight is a wonderful teacher. It allows one to learn from previous actions. Directors are protected from attacks on their decisions based on hindsight by a legal doctrine developed by the courts and known as the Business Judgment Rule.

Business Judgment Rule. The Business Judgment Rule is another doctrine that has undergone a gradual change over the years. Broadly stated, the Rule is that if the directors of a business acted in an informed basis and in good faith while making a decision, then the decision will be upheld despite any adverse consequences that resulted from the decision. In the past the Rule shielded just about all director decisions from attack. Absent bad faith, fraud or selfdealing on the part of a director, courts routinely refused to question the propriety of a board decision.

In the recent past a trend has emerged whereby courts will look more closely at the decision making process itself to determine if the directors acted reasonably. Three recent Delaware decisions where the Business Judgment Rule was raised have attracted much attention, in large part because of the results. (The attention is also the result of the fact that many corporations are incorporated in Delaware because of their favorable corporate and tax laws, and therefore decisions in that state affect many corporations and are often considered carefully by courts in other states). These decisions seem to signal that a closer review of director actions and decisions is emerging.

The three cases are *Zapata Corp. v. Maryland*, 430 A.2d 779 (Del.Sup.Ct. 1981), *Smith v. VanGorkum*, 488 A.2d 858 (Del.Sup.Ct. 1985). While the facts of these cases are not especially relevant to a cooperative, the careful and close scrutiny of the director decisions which the Delaware Supreme Court engaged in, despite

the Business Judgment Rule, *is* relevant. In both *VanGorkum* and *Moran* a challenge was made to decisions made by the boards in response to actual or proposed corporate takeovers. The court carefully looked at the time devoted to the decision, the complexity of the decision, the decision process itself, the amount of notice provided before the meeting, the availability of written information and data and the financial interests of the directors involved in the decision. The court reviewed much more carefully and completely the actions of the directors than has usually been done in the past. Therefore, the clear message for directors is that more careful scrutiny of the decision making process itself will now occur. A deliberate and well-documented decision is likely to be upheld. A hasty and ill-conceived decision will not withhold judicial scrutiny.

Because of increased exposure to risk of law suit, which is expensive even if the directors prevail, many persons are hesitant to serve on a board of directors. Two ways that a cooperative can offer protection to directors are indemnification and insurance. Each of these is discussed in turn.

Indemnification. Indemnification is the reimbursement of payments made by a director as a result of having been a director or officer of the business. The payments may be in the form of expenses, attorneys fees or reimbursement to the business, shareholders or others. Some state cooperative incorporation statutes permit the reimbursement of directors in appropriate circumstances. If the state cooperative incorporation statute does not specifically mention indemnification, then it may be possible to use the general business incorporation statute provision. In either case, the bylaws of the cooperative should contain a provision allowing such reimbursement in appropriate circumstances.

The question of what circumstances are appropriate ones for indemnification is not always an easy one to determine. Generally, it is required that a director have acted in good faith and believed his or her conduct was in the best interests of the cooperative or not unlawful, in the case of a criminal proceeding. Oftentimes, the business is not allowed to reimburse the director for payments that the director has to make to the business.

In many instances a clear decision about a director's culpability is not made. The most common situation in which this arises is when a claim is settled and no determination is made about the director's good faith and/or acting in the best interests of the cooperative. In this situation indemnification may be allowed.

The question of who makes the determination to indemnify or not to indemnify is thus raised. Similarly questions about the amount to be paid or to whom it is paid may be at issue. Depending on the circumstances, these decisions may be made by the remainder of the board, a committee of the board, a disinterested outside legal advisor, the shareholders or a judge. If there are enough board members not being sued to make a quorum or appoint a committee, then generally the

remaining board members make the decision. If all the board members are involved, then it is an outside legal advisor, the shareholders or a judge that makes the decision.

Although generally indemnification is a good idea, like any other good idea, it can be abused. Reimbursement for a director who was careless may encourage that type of behavior. Therefore, any indemnification bylaw provision should be carefully drafted. Similarly, the use of insurance to protect directors can also be abused.

Insurance. It is possible for a cooperative to obtain insurance to cover any payments that a director might be required to make. The provision of insurance coverage is somewhat controversial. Providing too broad insurance coverage may encourage directors to be lax in the performance of their duties and is to be avoided. Once again, a specific bylaw provision is a good idea. The terms of various policies may differ, and the cooperative should determine which types of director behavior it wishes to protect. Careful consideration by the directors while purchasing the insurance is required.

Conclusion. Members of the cooperative who serve as directors have the important function of overseeing the management of the cooperative. The directors must keep themselves informed, and act prudently while making decisions. If a director acts in good faith, is careful and deliberate in his or her actions, and avoids financial self-dealing or special treatment, he or she will encounter no difficulties in fulfilling his or her legal duties to the cooperative.

In addition, the special characteristics of a cooperative business require that the directors be sensitive to the needs of the members and make sure the members are educated so that they can exercise their rights.

Careful concern for and compliance with the duties and responsibilities imposed by law on directors will prevent problems. In addition, the use of indemnification and insurance further protects directors from burdensome financial liability.

Serving as a director is a responsible position, but it need not be a burdensome one if the director carefully observes the requirements set out here.

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