

LAW OF COOPERATIVES
—The Changing Boardroom for Cooperatives—

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The boardroom has changed more in the last four years than it has in the last 50 years. Until the 1990s, changes occurred so slowly in the boardroom that few persons, even directors, noticed the change. In the past, we read books by professors about boardroom changes between business eras. Today, boardroom changes are reported in the daily newspapers, and every month business journals try to analyze and summarize the impacts. While in earlier times changes occurred so slowly that they were almost unnoticeable, today boardroom changes are occurring so quickly that they are difficult to assess, much less implement.

In cooperatives, the Board governs the cooperative, and the business and affairs of the cooperative are managed by the CEO or general manager.

I. Director Duties and Responsibilities

The director has a responsibility to the cooperative to discharge his or her duties in good faith in a manner that the director believes to be in the best interests of the cooperative, with the care an ordinary prudent person in a like position would exercise under the same circumstances. Directors have a duty of care and loyalty to the cooperative and are entitled to rely on the business judgment rule in making decisions, typically to the same extent as a director of a Delaware corporation. Each director is required to devote the time necessary to govern the business and affairs of the cooperative, and outside of that may serve other businesses or enterprises so long as the other business is not a competitor of the cooperative.

In summary, directors must:

- discharge their duties in good faith
- take actions in the best interests of the cooperative
- devote the time and attention necessary to make informed decisions

Board Authority, Director Responsibility, and Liability. Although each director has the above duties, the authority to govern the cooperative and to make decisions relating to that governance lies solely with the Board. The concept is important but frequently misunderstood.

Director Represents Cooperative, Not Individual Members. Directors may be elected by groups or by all members, but their duty of loyalty is to the cooperative and its members as a whole, not to any particular electorate. (A director does not represent any particular member or group of members regardless of how elected.)

Only Authority to Act as Board, Not as Director. Other than by delegation or, if the chair, for procedural matters, a director does not have individual authority relating to the cooperative. Only the Board acting collectively has authority to govern. A director acting under individual authority does so at his or her individual liability.

Individual Director Responsibility. On the other hand, each director has the responsibility individually to carry out the duties of a director regardless of how the Board proceeds collectively.

Individual Director Liability. A director has personal liability for not discharging his or her duties in good faith regardless of how the Board acts.

Conflict: Director Duties and Board Actions. On certain issues, individual directors will find themselves at odds with a majority of the Board. The process of analyzing and taking appropriate actions relating to the conflict is fact- and circumstances-specific. If there is fraud or illegal activity on the part of management or the Board, each director has a duty and obligation to object and have the objection noted in the minutes of the

meeting, not only for that decision but for each decision that furthers the fraud or illegal activity. In addition, if the cooperative is a Securities and Exchange Commission reporting company, reporting obligations may arise.

If the action or decision is one of business judgment upon which there is no one right answer, the appropriate process is for the directors to discuss and analyze the issue and for the Board majority to reach a decision. Each director has a duty to support the governing authority of the Board to make business decisions even though the director may not personally support a particular decision. The minutes reflect the Board deliberations and decisions. Directors must not undermine the authority of the Board by repeating confidential Board discussions or business information outside the boardroom. Although minutes need to reflect the Board process, directors should note the truism that “minutes are most often and most carefully read by your enemies.” A director accepts the structure and Board authority of the cooperative when the director accepts the director position.

In between fraud and criminal actions and business decisions are actions and decisions that the director may believe threaten the cooperative or will damage the interests of the members collectively. Facts and circumstances will dictate the response, but a dissenting director has a duty to present his or her view to the Board, have the dissenting view and his or her dissenting vote noted in the minutes, and, if the action is significant enough that the director believes the other directors are derelict of their duties, the dissenting director should consider resignation from the Board, among other things.

II. Increasing Liability for Directors

Three general areas have had an impact on increasing potential director liability to members in situations in which there is a business loss to the cooperative: the Sarbanes-Oxley Act, Delaware case law, and directors and officers insurance.

Sarbanes-Oxley. The Sarbanes-Oxley Act and related rulemaking (collectively “SOX”) enhance the risk of liability. Although SOX does not modify duties or standards of director conduct, SOX requires the financial auditing and corporate obligations that are becoming “standards” against which to measure appropriate conduct. SOX also allows private causes of action for violations and lowered the requirement for the Securities and Exchange Commission to bar a director from serving on a board by determining the director to be “unfit.”

Although much of SOX does not apply to cooperatives, regardless of size, it is likely that the liability concepts of SOX will be argued in common-law actions in state courts that will impact cooperatives. SOX has had the subtle effect of influencing state fiduciary requirements and setting into effect increasing expectations of directors.

Delaware Law. Delaware law traditionally shielded directors from liability through exculpatory or liability waiver provisions. The bylaws of a cooperative generally eliminate personal liability of directors for duty-of-care violations and decisions within the business judgment rule.

Traditionally, directors would only face liability if they personally misled or defrauded the company or personally profited at the expense of the company. This is referred to as a “breach of loyalty” to the company. Cooperatives do not indemnify directors for actions involving these types of breaches of loyalty. Today, however, Delaware courts are raising the expectations, and as a result the potential exposure, of directors in the area of “good faith,” which is required of cooperative directors in discharging their duties. The Chief Justice of the Delaware Supreme Court has stated that directors of Delaware companies will be held liable for lack of good faith and that directors, among other things, should:

- embrace best practices in the governance process
- have a reasonable corporate understanding of the company’s business, competitive environment, financial controls, and financial disclosures
- actively engage in Board discussions and deliberations with healthy skepticism and constructive criticism
- resist a culture of complacency when things are going well
- rely in good faith on well-chosen experts

The judge’s comments in conjunction with three higher-profile court decisions have eroded some of the expectations of liability protection for directors.

Disney. Directors allegedly violated fiduciary duties by spending less than one hour reviewing the hiring of an executive and approving a \$120 million employment agreement for barely one year of service. Delaware court ruled that the “process” used suggested a lack of good faith and that directors may not be protected by liability limitations and indemnifications in company articles and bylaws.

Abbott Laboratories. Directors allegedly knew about Food and Drug Administration violations for years and did nothing about it. Court held directors could be held personally liable because of conscious disregard of known risks, which is bad faith.

WorldCom. Federal securities law case with somewhat lower burden of proof involving \$108 million directors and officers insurance policy with threat of rescission by the insurer. Financial directors had pleaded guilty. Ten outside directors settled for \$36 million from directors and officers insurers and \$18 million from the directors’ personal assets (20 percent of directors’ personal nonexempt assets). Lead plaintiff made personal payment by directors a requirement for settlement.

Enron. The case involved Securities Act § 11 claims and directors and officers insurance with \$350 million limits. The parties settled for \$168 million, of which \$13 million was from personal assets of outside directors, representing 10 percent of pre-tax payouts from sale of Enron stock during period of fraudulent financial statements.

Directors and Officers Insurance. Directors customarily rely on directors and officers (“D&O”) insurance for financial protection against D&O claims. With larger, “headline” cases, carriers have rescinded or threatened to rescind policies based on fraudulent financial information when the policy was acquired. In a recent case, a D&O carrier argued to rescind a D&O policy after the company’s former CFO pleaded guilty to conspiracy to commit securities fraud. The carrier argued that the Form 10Q submitted with the insurance application overstated revenues. In the initial case, which was later appealed, *the court found that the policy could be rescinded even to innocent directors and officers who did not know about the fraud.* In other cases director coverage was jeopardized because initial claims against management or aggregate limits limited director recovery.

In general, Delaware law does not allow indemnification of directors for expenses or the cost of settlement if a director did not act in good faith to the company.

III. Will Corporate Actions Affect Cooperatives?

The names of Enron, WorldCom, Abbott Laboratories, and Disney may make the above issues seem remote and not applicable to cooperatives. Small and mid-cap companies and cooperatives have not been in the spotlight,

but the liability trends are being established with the large-cap companies. Commentators have suggested that small and mid-cap companies are becoming increasingly attractive to plaintiffs' lawyers, which suggests cooperatives may also be attractive. They reason that large-cap cases drag out for years, and cases against small and mid-cap companies take less time to settle or try, making those companies attractive targets. In addition, almost half of the financial restatements, a leading indicator of ensuing securities litigation, have been made by companies with less than \$100 million in revenue (Huron Consulting Group, 2003 Annual Review of Financial Reporting Matters).

Liability Affecting Producer-Owned Companies. For producer-owned and -controlled companies, liability trends that parallel the large corporate cases are also emerging. Although the following two cases were settled on different grounds, the initial suits show corporate-type claims that can be made against cooperative directors.

Minnesota Corn Processors. In the Notice of Class Action Settlement, the plaintiff members and members filed a class action alleging that former Minnesota Corn Processors ("MCP") officers and the chair of the Board breached fiduciary duties and were unjustly enriched, and the wrongful conduct resulted in inadequate consideration to MCP members. The defendants agreed to pay \$5.75 million to settle the allegations, which would be paid to members with the right to vote, but *excluding the MCP directors who voted for the merger* and the named defendants.

Farmland Industries Inc. A lawsuit filed by the liquidating trustee accused 29 former directors and officers of breaches of fiduciary duties through gross negligence, disregard of duty, and acts of corporate waste as part of entering into ill-conceived transactions, which showed an overwhelming abdication of their duties and led to the company's collapse. The first count alleged the Board approved a \$300 million fertilizer complex after inadequate due diligence and no investigation of alternatives to and risks of the transaction. Two similar counts related to an acquisition that included an assumption of \$100 million in debt, and assumption of catastrophic levels of debt to focus on growth over profitability. The fourth count was based on the approval of a \$700,000 bonus for the CEO when the CEO's primary duty was to work for the merged entity and no merger took place, and the CEO failed to meet written performance goals set by the Board for the CEO.

IV. Guidance for Directors

The job and position of director has and will continue to change with more responsibility and greater potential liability for mistakes. The first issue for existing or new directors is to evaluate the cooperative and the job of being a director. The Chief Justice of the Delaware Supreme Court estimates that 100 hours per year for ordinary board activities is not unreasonable. For many cooperatives, two hours per week is probably not enough time for a director to:

- understand the strategic business plans of the cooperative and fundamental structural changes in the industry in which the cooperative operates
- understand the nature and type of the cooperative's competition
- understand and monitor the cooperative's business plan, management's implementation of the business plan, and the operations of the cooperative
- review and understand the financial information of the cooperative
- act in good faith on each transaction and comply with the law
- use good-faith reliance on consultants, advisors, and management, which will require reading and understanding

Notwithstanding the court decisions cited, the law continues to protect conscientious directors who exercise due care, good faith, and independent judgment in the best interests of the company. The business judgment rule is still the best protection for a Board making careful, good-faith decisions, even if those decisions turn out wrong.

The interest of the cooperative's members will be advanced if directors assess risks, rewards, costs, and benefits to obtain the highest available risk-adjusted returns. Directors must take into account and accept that some business decisions will be wrong but that process will protect them from liability.

With increased awareness of director liability, directors need to be aware of limits and limitations of liability and indemnification under the articles and bylaws of the cooperative and under applicable D&O policies. Some companies are separating director and officer policies, and considering director endorsements and order-of-payment language.

As directors move forward in the changing boardroom environment, directors must know their cooperative, and its business and its management, and assess the commitment necessary to provide the oversight and direction their company requires.

The three primary challenges for producer-owned businesses will likely be areas of potential liability: capital, liquidity, and enterprise value. Producer-owned businesses are less accustomed to assessing enterprise value, and thinly traded equity interests reflect disparate member and shareholder assessment of value compared to how the market would assess enterprise value. These different views of value are a prime driver in member or shareholder suits and present vexing problems for directors and management as they govern and manage the company.

Directors and management are expected by members to lead their cooperatives to financial success. Good-faith, reasonable decisions, even if they are wrong, have not drawn director liability.

In summary, evaluate the demands, responsibilities, and liabilities of being a director. Understand the limits of D&O insurance. Insist on good corporate governance practices for the cooperative and use good-faith reliance on consultants, management, and advisors.