



# Legal Duties and Responsibilities of Co-op Board Members

By Kathryn Sedo

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

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.

## GENERAL DUTIES AND RESPONSIBILITIES

The legal standard of conduct required of directors of any business is found in state statutes and court decisions. An ongoing attempt to codify the standard has been made by the American Bar

Association, and is named the Model Business Corporation Act (1994). Chapter 8 of the Model Act is entitled "Directors and Officers." Subchapter C of this chapter contains the general standards of conduct that are required of 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;
  - (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.

Subchapter F goes on to define director "conflict of interest," discussed below.

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 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 and experts, and monitoring 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 that 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 such reports, the director must have read it or be at a meeting where a verbal presentation was made. The general standards contained in Subsection (a) above — good faith, ordinary care, and best interests — apply when judging whether reliance on a report was reasonable.

Close monitoring of employees and committee work is also required. It is important that 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 concern of self-dealing and dealing with someone who otherwise would have 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 arm's 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 usurping "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 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 director must act in good faith and 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. The results of directors' decisions need not always be positive in hindsight, but decisions must be 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 decision 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 on 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 self-dealing on the part of a director, courts routinely refused to question the propriety of a board decision.

## **LEGAL DUTIES**

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

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), and *Moran v. Household International*, 490 A.2d 1059 (Del.Sup.Ct. 1985). While the facts of these cases are not

especially relevant to a cooperative, the careful and close scrutiny of the board's decision making process which the Delaware Supreme Court engaged in, despite the Business Judgment Rule, is relevant. The court carefully looked at the following:

- the time devoted to decisions,
- the complexity of decisions,
- the decision process itself,
- the amount of notice provided before meetings,
- 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 board than has usually been done in the past.

## **INSURANCE AND INDEMNIFICATION**

Because of increased exposure to risk of lawsuit, which is expensive even if 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. In addition, some states (e.g., Minnesota) allow cooperatives to limit the liability of their board members in their Articles of Incorporation. Each of these is discussed in turn.

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, attorney fees, or reimbursement to the business, shareholders or others. Some state cooperative incorporation statutes permit such reimbursement to 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 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).

In many instances, a clear decision about a director's culpability is not made. More commonly, 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. Similar questions about the amount to be paid or to whom it is paid may be at issue. Depending on 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.

Although generally indemnification is a good idea, like any good idea it can be abused. Reimbursement for a director who was careless may encourage such behavior. Therefore, any indemnification bylaw provision should be very carefully drafted.

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. 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.

Minnesota's cooperative incorporation statute allows cooperatives to eliminate or limit the liability of its board members in the cooperative's Articles of Incorporation (Minn. Stat. 308A.325). The cooperative may not limit or eliminate liability for:

- breach of the duty of loyalty;
- acts or omissions not in good faith or that involve intentional misconduct or knowing violation of a law;
- or a transaction from which the director derived improper personal benefit. Cooperatives that incorporated in states whose statutes contain similar provisions should consider amending their governing documents.

## 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 director 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, indemnification, insurance, or provisions in the Articles of Incorporation limiting liability (where permitted) can further protect 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 legal requirements of the job.

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### **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 and 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 directors' 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.