

Co-ops Nearing Insolvency Must Be Less Cooperative

Governance Challenges Grow for Financially Troubled Co-ops

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Cooperatives form an integral and unique part of American history. Born of the notion that, acting collectively, a group of individuals can accomplish common goals that each individual acting alone cannot, cooperatives in the early years of the 19th century were seen as a way not only to earn a living, but also to combat the influence of powerful private-sector interests and the often severe consequences of the boom-bust economic cycle.¹ Moreover, through the period that ended roughly with the conclusion of World War II, moral and religious concerns underpinned the need for and value of cooperatives as much, if not more so, than business interests.²

To be sure, the idealists had their pragmatic counterparts, those who recognized that and, irrespective of any social purpose these commercial undertakings were formed to serve, cooperatives could not survive without a sound business model. Indeed, one commentator suggests that since World War II, the pragmatists have exerted too much dominance, causing cooperatives to lose sight of the larger, more socially oriented goals of their origins.³ Modern governmental literature also tends to emphasize the business aspects, rather than the social goals, of cooperatives.

Irrespective of where one draws the line between ideology and pragmatism generally, the latter certainly must carry the day when a cooperative is in financial trouble. Once a cooperative approaches the vicinity, or zone, of insolvency, it and the people who run it are governed by law dedicated not to the form of the business, but to its lack of financial health.

More fundamentally, in restructuring the financially troubled business, managers, directors, and members may be forced to consider whether it can or should remain a cooperative.

Cooperative Structure

*Cooperative: A user-owned and controlled business from which benefits are derived and distributed on the basis of use.*⁴

Cooperatives are creatures of statute, a form of corporation organized under state law and governed by articles of incorporation and bylaws, much like their investor-owned corporate counterparts. Compliance with certain state and federal statutes is essential to a cooperative retaining its status, such as the limited antitrust exemption cooperatives enjoy or limitations on the amount a cooperative can distribute as dividends.

Apart from these statutory mandates, and despite the similarities with corporations, it is the emphasis on the user that truly sets the cooperative apart, as reflected in these three cooperative principles:

- **User-Owner Principle:** The cooperative is owned by the people who use it.
- **User-Control Principle:** The cooperative is controlled by the people who use it.
- **User-Benefits Principle:** The benefits generated by the cooperative accrue to its users on the basis of their use.⁵

Three core groups operate in furtherance of these principles and the cooperatives goals:

Members. A cooperative's members are its lifeblood because, unlike stockholders in a corporation, members view the cooperative more in terms of the goods and services it

provides than as a financial investment. Members seek market access for goods or services, and a cooperative is organized around its members' needs. In addition to market access, members benefit from patronage, receiving cash refunds based on their own use of the cooperative.

Members of a cooperative also have a greater say in the business. Voting is generally on a "one member, one vote" basis, not the proportional voting accorded to corporate stockholders. Member voting also more directly affects leadership. Directors are elected by the members themselves, an issue that is currently one of significant controversy in the investor owned firm (IOF) world.⁶

Directors. Elected by their members, the directors of a cooperative have a similar function and responsibility as those serving on an IOF board. The members generally are responsible for setting the cooperative's policies, employing a general manager to carry out those policies, and evaluating the manager's performance.⁷ It is not uncommon for directors to also be members of the cooperative, a situation that can lead to troublesome situations, as will be discussed in more detail later.

Manager. A manager is retained by the directors and is the rough equivalent of the CEO of an IOF, in that both are responsible for the daily operations of the cooperative. But a cooperative manager is, relatively speaking, much weaker. The manager usually has significantly less influence over who sits on the board and therefore, a diminished ability to set, rather than just to implement, the cooperative's policy.⁸

Managers are also much more likely to have direct contact with their cooperatives' members than a CEO would with shareholders because "user-owners and directors invest in and guide the firm specifically to obtain services for themselves and the other members. They often have regular contact with employees and other producer-owners."⁹

Each of these three groups has responsibilities to the cooperative. Although not legally required, members are expected to patronize the cooperative and should maintain a high degree of loyalty to it. Inspiring that loyalty, however, is a function of leadership.

Beyond these aspirations is a legal duty. Directors and, depending on state law, managers are fiduciaries and, as such, owe to the cooperative and its member-owners utmost trust and loyalty. Self-dealing and similar misconduct obviously are not permitted but, more generally, a cooperative's fiduciaries must act in the best interests of its members. From a legal standpoint, this duty is virtually indistinguishable from that of corporate directors and officers, whose loyalty is to the corporate owners, the shareholders.

The cooperative director, on which the remainder of this article is focused, perceives this duty differently because it is not a function of profit for the benefit of a passive and usually unknown investor. Rather, for cooperative directors, the fiduciary duty is part of an overall "what's good for the members" mindset — with those members often being known personally to the directors and involved in the business — that is at the philosophical and practical heart of the cooperative.

Insolvency

*"We judge ourselves by our intentions while others must judge us by our behavior."*¹⁰

Insolvency, whether actual or approaching, dramatically affects the duty directors owe to the cooperative and its members. Once a cooperative enters the zone of insolvency, the duty begins to shift away from members and toward other stakeholders, most notably the creditors of the business.

In a corporation, this shift is often manifested in reduced risk-taking because the company's assets must be preserved for the benefit of creditors. In a cooperative, the shift in directors' fiduciary duty alters the very basis of decision making because focusing primarily on members' benefit is precisely what is not allowed in the vicinity of insolvency.

Consider the following examples that, although hypothetical, could easily arise in the course of a cooperative's business:

- A cooperative operates locations around the country, most of which are profitable. The directors determine that the profitable cooperatives can absorb the losses incurred by the others; therefore the unprofitable locations are kept open.
- A cooperative continues to purchase goods from its members even after it has purchased all that it can sell.
- A cooperative sells a product to members at less than cost to keep the price of the product below that of a non-cooperative competitor.

In a cooperative, the shift in directors' fiduciary duty alters the very basis of decision making because focusing primarily on members' benefit is precisely what is not allowed in the vicinity of insolvency.

In each of these admittedly oversimplified examples, the directors made decisions they believed to be in the members' best interests. The directors' decisions may not be sound from a business perspective, even for a healthy cooperative. But in the vicinity of insolvency, these decisions are simply not allowed because of the directors' shift in duty away from the members and toward the cooperative and other constituencies, especially creditors. Put more simply, the directors' duty in the vicinity of insolvency is to maximize the cooperative's overall value.

The modern incarnation of a director's duty in the vicinity of insolvency comes from a Delaware court's now well-known decision in the *Credit Lyonnaise* case, in which the court stated: "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."¹¹ The *Credit Lyonnaise* court further opined in a footnote that the vicinity of insolvency signals a shift in the directors' loyalty away from shareholders and toward the "community of interests that the corporation represents," including creditors.¹²

As a general rule, directors do not owe creditors any duty beyond those arising from contractual obligations. But insolvency is one of a handful of exceptions to that general rule. As a later court, again in Delaware, explained:

[Directors] continue to have the task of attempting to maximize the economic value of the firm. That much of their job does not change. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders — that of residual risk-bearers. Where the assets of the company are insufficient to pay its debts, and the remaining equity is underwater, whatever remains of the company's assets will be used to pay creditors, usually by seniority of debt or on a pro rata basis among [creditors] of equal priority.¹³

As its name suggests, the vicinity of insolvency is not a concept that is clearly defined, nor have the courts articulated the precise duty directors owe and to whom it is owed once the vicinity of insolvency is reached. What is clear is the risk of liability for directors who might find themselves facing any or all of the following:

- **Suits By or on Behalf of Creditors.** So far, the courts have not embraced the notion that insolvency serves to substitute creditors in the place of owners as the direct object of directors' fiduciary duty. Stated differently, although insolvency creates a duty to creditors, the question centers on the scope of the duty that is owed.

Many of the decisions in successful suits by creditors have involved actual diversions of assets to insiders or preferred creditors rather than the simple fact of insolvency and consequent harm to the creditor. As one court explained it:

None of the cases in which directors were held to have breached their duty expanded the directors' obligations to creditors beyond what the contract already provided. On this theory, creditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy their claims. That is the appropriate scope of a duty that exists only to protect the contractual and priority rights of creditors.¹⁴

Creditors' suits are not limited to individual actions. Trustees or other estate representatives might sue directors, asserting claims that are either common to the creditor body or assigned to the trustee by damaged creditors.

In the examples described earlier, the creditors or estate representative would have a claim against the directors for preferring the members over creditors and possibly for the diversion of cooperative assets to members, whose interests are legally subordinate to those of creditors. This is not to say the directors intended any harm in any of the examples; to the contrary, in each, the directors acted in the manner to which they were accustomed, making member benefit their foremost concern. Irrespective of intent, however, the directors' behavior caused a violation of their duties once in the vicinity of insolvency because those duties shifted away from members and toward maximizing the value of the cooperative and ensuring the satisfaction of creditor claims.

• **Suits by a Trustee or Estate Representative for Harm to the Cooperative.** There is growing acceptance in case law that a bankruptcy trustee or similar estate representative can seek damages from directors and others for the harm their actions caused not to a company's creditors, but to the company itself. Falling under the general heading of "deepening insolvency," which is too big a topic to address in detail in this article, the outcome of these actions is far from predictable because of conflict and as-yet unanswered questions in the case law. Claims of fraud, negligence, or similar misconduct are common to deepening insolvency actions, but they are increasingly premised on director actions that moved the company to, or caused, insolvency, independent of any other alleged wrongdoing.

Returning again to the earlier examples, the directors face a situation very much like that with respect to creditor suits. The difference is that it is the cooperative itself that is the focus of the duty and the extent of harm to it resulting from the directors' decisions. Depending on the jurisdiction, the directors' intent in taking the particular actions may be relevant if the court requires evidence of fraud or a scheme to loot the cooperative. The law is unsettled in this regard, however, and some courts will look at the outcome — diversion of assets from the cooperative to its owners — rather than at what the directors intended or the behavior that caused the harm.

• **Suits by Members.** Despite the shift in directors' duty toward creditors, members' interests cannot be forsaken and the directors' actions may give rise to a legal claim by members for harm occasioned by the directors' actions. In this regard, the examples used thus far present no obvious problem for the directors. After all, it was the benefit members received that caused the problems for the directors, so the members have little basis on which to complain.

The situation changes if one takes into account the complexity of actual cooperatives, rather than the simplified situations suggested here. Cooperatives can be large entities, with some having international reach, made up of different lines of business and having other cooperatives as members.

Further complicating the matter for a cooperative within the vicinity of insolvency is the multiplicity of roles that members, managers, and directors actually play. Any member can be a director. Managers commonly rise from the ranks of the membership. Members can be creditors and customers of the cooperative. This multiplicity, combined with the sometimes murky and often dangerous vicinity of insolvency, creates an imperative that directors, as well as managers and members, understand the rules of the game before it gets underway.

Restructuring a Cooperative

The redirection of director loyalty at the vicinity of insolvency is frequently just the first of many steps in the reorganization of financially troubled businesses, including cooperatives. The underlying principle remains constant, however, and all of the many restructuring decisions directors must make carry with them the obligation to maximize the value of the cooperative for the benefit of creditors. The harsh reality of laws governing insolvency is the expectation that owners, irrespective of the business form, must bear the greatest risk of loss. For cooperative members, the loss could range from a temporary forfeiture of patronage refunds to an end of the cooperative form altogether.

But the news is not all bad. The most drastic results of insolvency and restructuring can be avoided if their possibility is incorporated into the business model from the outset. With competent, effective leadership and education for members that includes the effects of insolvency on the cooperative and its constituents, cooperatives can be guided through periods

of financial difficulty while remaining true to their more idealistic principles. [ER](#)

¹ Rural Business-Cooperative Service, U.S. Dept. of Agriculture, "Strengthening Ethics Within Agricultural Cooperatives," 9 (1997).

² Greg Lawless, "Historic Foundations of Cooperative Philosophy," *University Of Wisconsin Center For Cooperatives Bulletin*, No. 7 (Sept. 2003).

³ Id.

⁴ Rural Business-Cooperative Service, U.S. Dept. of Agriculture, "Strengthening Ethics within Agricultural Cooperatives," 10-11 (1997).

⁵ Rural Business-Cooperative Service, U.S. Dept. of Agriculture, "Agricultural Cooperatives in the 21st Century," 1 (2002).

⁶ See e.g., Phyllis Plitch, "Delaware Law Panel to Mull Majority Vote in Bd Elections," *Wall Street Journal*, Aug. 25, 2005.

⁷ Rural Business-Cooperative Service, U.S. Dept. of Agriculture, "Cooperative Management," 22 (1997)

⁸ Rural Business-Cooperative Service, U.S. Dept. of Agriculture, "Agricultural Cooperatives in the 21st Century," 11 (2002).

⁹ Id.

¹⁰ Rural Business-Cooperative Service, U.S. Dept. of Agriculture, "Strengthening Ethics within Agricultural Cooperatives," 4 (1997).

¹¹ *Credit Lyonnaise*, 1991 Del. Ch. LEXIS 215, *108 (Del. Ch. Dec. 30, 1991).

¹² Id. at n.55.

¹³ *Liquidation Trust of Hechinger Inv. Co. v. Fleet Retail Finance Group (In re Hechinger Inv. Co.)*, 327 B.R. 537 (D. Del. 2005) quoting *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

¹⁴ *Steinberg v. Kendig (In re Ben Franklin Retail Stores)*, 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998) (internal citations and quotations omitted).

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