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Benefiting from the Board: A Case Study

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Introduction

Boards of directors have been part of the Anglo-American business model since the 16^{th} century. The owners of corporations are represented by directors, who are charged with managing the affairs of the firm. In cooperative firms, where the owners are also the users of the firm, the directors are elected from among the people who use the firm's products and services. This means that employees govern worker cooperatives, shoppers are the board members of most grocery cooperatives, and farmers are the directors of cooperatively owned agribusinesses. In contrast, investor-owned corporations are governed by a board that usually includes the CEO, senior managers and a selected group of "outside" directors, recruited for their management experience, professional expertise or knowledge of the firm's business environment.

Some observers have commented that cooperative directors are unable to advise management effectively because they lack the resumes of investor-owned boards. Descriptions of cooperative failures or conversions to investor-ownership have sometimes blamed the farmer-led boards for a lack of skills or ability to set the strategic direction of the firm. (Hardesty 2005, Keeling 2004). Cooperative boards are regularly advised to recruit non-member directors to improve the skill-set of the boards, (Dunn 2002). The farm credit system allows bank and association boards to appoint non-member voting directors, for "specific public policy purposes, such as facilitating diversity or acquiring needed skills. (Pellett, 2006).

Although the cooperative advisory literature has expressed concerns about the ability of co-op board members to govern effectively, there is almost no empirical research examining the relationship between board characteristics and cooperative firm performance. In one of the few recent studies of cooperative ownership theory, Hansmann (2000) argued that the governance of farm supply cooperatives has been an important factor in their success. Their owners understand the business well and participate actively in its governance. These cooperatives have a significant market share, and their ownership model, where customers oversee the firm and share strategic customer information, may be a source of competitive advantage over investor owned firms. Corporate board members serve as significant resources to management, but they rarely bring a customer perspective to the board room (McGovern 2004).

This paper demonstrates how a board of firm users played a critical role in advising management on customer preferences. The paper begins with a review of current thinking on how the boards of cooperative and corporate firms advise management, and then examines the structure and interactions of the board of a successful farm supply cooperative. By describing board behavior in one cooperative in detail, this paper helps us understand how customer information flows credibly from the board to management to influence the strategic direction of the firm.

The Advisory Role of Directors

In order to be effective, boards must maintain a balance between their oversight and advisory roles. Although approaches to alleviate agency problems have dominated research on governance, governance experts have advocated for collaboration between the board and CEO.

For example, John Pound offered this advice in the *Harvard Business Review*: "At its core, corporate governance is not about power but about ensuring that decisions are made effectively" (Pound, 1995).

Recent studies have furthered our understanding of the process used by boards to make decisions effectively. Some of these studies dispute one of the central approaches to the agency problem, which is to increase the board's independence from the CEO. Boards with good relationships with the CEO may have better access to information, and serve as better advisors than boards that are in conflict with the CEO (Adams 2007). A study by Westphal (1999) suggested that board-CEO social ties would help to foster a collaborative environment, where CEO's seek the advice offered by directors. Social connections between the board and CEO may mitigate the CEO's reluctance to lose status by seeking advice from a superior, which, in this case, is the board.

Even when the board/CEO relationship is good, and the board receives accurate information, experienced and skillful independent board members may find it difficult to give useful advice to the CEO. In a 1989 study, 30% of corporate board members reported that their contribution to board meetings had minimal value (Lorsch, 1989). They lack the expertise that comes from day-to-day involvement with the firm. A study by Hill and Snell (1988) found that firms that are planning major innovations bring more inside directors onto the board, hoping to better integrate functional operations with strategy. Although inside directors theoretically contribute to agency problems, a recent meta-analysis of governance literature reports modest to negligible evidence of a relationship between firm performance and board composition (Dalton 2007). Inside directors have the advantage of vastly superior knowledge of the organization, and may have a longer term interest in its success. (Baysinger 1990, Hoskisson, 2002). Another source of strategic information is board members who sit on several boards. They can contribute positively by bringing strategic information about an industry or a range of opportunities to the board room (Carpenter and Westphal, 2001).

Regardless of the composition of the board, most advising takes place behind the closed doors of the board room and is largely off limits to observers. Hermalin and Weisbach (2003), in their survey of governance literature, noted the importance of better modeling of the relationship between the board and CEO. They point out that although little is known about the inner workings of the board, it is likely that economic models aren't as useful for understanding the small group dynamics of a boardroom as recent experimental work on notions of fairness and the importance of social norms. These dynamics affect all boards, regardless of the objective role of the organization.

While acknowledging the universality of many small group interactions, it's important to note the distinguishing characteristics of cooperative boards. The majority of cooperative directors are users of the firm's products and services, with some financial investment in the firm. They share characteristics with corporate management (or "inside") board members because they have a long-term stake in the firm, their investment is relatively illiquid, and they have significant knowledge of aspects of the firm. At the same time, they are independent directors because they aren't employed by the firm and, as owners, have strong incentives to monitor management. They represent their fellow consumers and users of the firm's services. They usually have a long term relationship with both the cooperative firm and the owners they represent. Although these owners may have a degree of homogeneity, they will have varied interests. A farmer-owned cooperative, for example, will typically include members with significant differences in their business volume and time horizon as patrons of the firm. These diverse interests may be in conflict (Cook, 1995, pp 47-9) and are usually represented in cooperative board rooms (Reynolds, 2003).

Nevertheless, the presence of consumers on the board may be a source of competitive advantage for cooperatives. Many corporate boards spend less than 10% of their time on customer-related issues**.** (McGovern, 2004). Popular metrics, such as retention rates and customer satisfaction are often poor indicators of customer perception of the firm. Customers are often unwilling to share information on product satisfaction (Bowen 1989) and many costly computer-based customer relationship management projects result in losses or no bottom-line improvement (Reinartz 2004). In spite of the challenges, satisfying existing customers is closely linked to corporate profitability and strategic competitive advantage (Barnes 1994). Corporate governance experts advise boards to test proposed strategic initiatives by asking questions that focus on customer purchase decisions and perceptions of the firm (Seymann 2008). A cooperative board of customers should be adept at making customer value the focus of strategic decision-making.

The Case study

A case study was conducted of a successful farm supply and marketing cooperative to better understand the role of the board in advising the CEO. The study included 4 observations at board and committee meetings, interviews with five board members and the CEO, and many informal conversations during a six month period in 2007.

This cooperative has grown steadily over the past decade, as mergers and acquisitions have expanded the trade territory into more than 12 counties. Sales growth in 2007 was over 30%. The cooperative has a large energy marketing division, grain elevators, feed milling operations, agronomy, a heating and cooling division and several convenience stores. The cooperative has over 1,000 farmer members. They purchase their seeds, fertilizer and other services from the co-op, and the co-op buys and sells their corn and soybeans. The co-op also owns gas stations and sells propane and diesel.

Although any patron of the cooperative can be a member, only producers of agricultural products, worth over $1,000, can vote and serve on the board. There are nine board members, who own farms that range from small to very large. Demographically, they are all male, all white, and their ages range from mid-30 to 60. Directors feel positive about their fellow board members. As one board member commented, “I think every person in there is a pretty good thinker, a pretty high end guy, as far as I’m concerned.”

Listening to the customers

The directors of this farm supply cooperative are well-positioned to bring customer feedback into the boardroom. They use the facilities themselves and hear comments from other members, so they know when improvements are needed. They understand the factors behind the choices that members make when they're deciding whether to use the co-op's services, since they're making the same choices themselves. They have a good feeling for the context of these choices – the constant series of tradeoffs that consumers make between benefits such as price, convenience, and quality. They're also sensitive to the complexities of brand and firm loyalty, recognizing that there are generational, geographic, and general altitudinal differences throughout their territory.

Because board members are respectful of their fellow-board members' role in their communities, they trust the feedback that directors collect through their network of friends and colleagues. Directors commented on the importance of those connections:

> "I think everybody has a pretty good sense of what's going on in their community. And so if there's something going in their area, that's good, bad or otherwise, they seem to know it and they bring it up."
>
> "Our nine board members now, we're spread out well through the territory. We get a feel for what other people are thinking."

Board members haul grain to the co-op's terminals during harvest, they depend on fuel deliveries, and they purchase agronomy services. They interact regularly with the employees at one or more of the co-op's 12 locations, and they have first-hand knowledge of the stresses on co-op staff during the planting and harvest seasons, when every member demands the same services. They purchase on credit, and they use the co-op's risk management services. Board members are well aware that their opinions are shaped by their own business needs, balanced by their responsibilities to all members. A board member talked about the dilemma:

> "You try to represent all of them, but you tend to think in terms of your own business. You can hardly help that. It's like the dairy here. You think of what works, and why it's not working here, and what you could do to make it different. I think that you bring your own operation into it, whether you think you do or not."

One of the contentious issues for this board was a credit policy, and the discussions on possible changes highlighted the directors' advisory role. The current policy was a holdover from a policy used by one of their merger partners, so it was well accepted by the former members of the merger partner, within a section of the trade territory. The agronomy division used the policy, and derived a direct benefit to their thin bottom line. Staff and board members also understood that the policy was a problem for some members and prospective members. The finance committee met to review management's proposal to change the policy, and then brought the issue to the board room for discussion. Directors had questions about the financial analysis, and asked about their competitors' policies. They talked about the negative effect of the change on agronomy's bottom line, and asked about the level of member dissatisfaction. As it became clear that there were still serious concerns with the proposed change, the chair suggested that the issue return to the finance committee for more consideration, and that interested directors attend that meeting. There were no deadlines for the credit policy change, and there was a general agreement to continue the discussion toward consensus. After the meeting, a board member described the quandary facing board members:

> "Most of the tougher stuff, like at the last meeting, is the finance stuff. You're talking about interest rates that people are going to have to pay. You don't want to encourage

> people to carry balances, but yet you don't want to be too out of line with industry standards. The board is trying to make sure it's fair. We're there to make sure that we don't alienate the customers, the members."

Another proposal before the board was to upgrade a grain handling facility. As the CEO drew diagrams of the proposed improvements, and staff proposed alternatives, board members raised issues related to service, issues that would have a direct effect on members' satisfaction:

> "We need to plan for receiving also. We need to speed up the receiving process."
>
> "The biggest bitch in the country is the elevators shutting down at 5 – 6:00. Farmers want to dump later in the evening. Even if you can go to 9 or 10 at night, you'd be a hero. But the guys that bring it in the late are the guys that you want to be a hero to."

The improvements required some shifting of resources, but they were part of the capital budget, had been discussed at length in committee meetings, and were approved fairly easily. At the next meeting, an un-budgeted capital expenditure required more discussion. One of the division managers came to a board meeting with a proposal for significant expenditures on another facility. He apologized for making the request, but indicated that he needed an answer soon in order to have the facility in place in time for the fall season. He distributed a 25 page booklet and reviewed the details of his request. The request had been reviewed by one of the committees, but the division manager was questioned quite closely by both board members and other members of the management team. Board members asked about the flexibility of the facility, and its impact on next year's capital budgets. The board chair asked, "Would the board see relief in your capital budget for 2008?" The division manager reviewed his plans for capital expenditures over the next five years. Then he was asked to excuse himself so the board could continue the discussion. A board member who owned a large operation commented, "From a customer side, if the equipment isn't there at the co-op, I'll buy my own. This holds our customers." After more discussion, the board approved the expenditure request.

When asked about important board decisions at the co-op, several directors mentioned the recent change in equity policies. Most farm supply cooperatives rely on retained profits for their equity, which are recorded in member accounts, based on the annual patronage of each member. Directors are responsible for the policies that govern the retention and pay-out of this equity to members. These decisions often require maintaining a challenging balance between the firm's capital needs and members' expectations that their equity will be paid out. Directors must balance these competing interests, which may be in direct conflict.

The cooperative recently approved a change to their equity policies that benefited their most active customers. The board chair described a meeting where the board decided it needed to take action:

> "We spent the whole day, with our banker, trying to get into his head, and trying to get him into ours. I think it showed our board at that point…the need to be profitable. It showed them how profitability translates into borrowing ability, and liquidity. How important it is that we pay off our old equity, you know."

After coming to agreement on a new plan, the cooperative mailed flyers to all members, explaining the impact on members' equity accounts. Board members were given extra copies for members they happened to meet, and a couple of informational meetings were held. The new plan allowed the co-op to speed up payments to larger customers. Members with small equity accounts would have to wait until death or old age for a payment. A board member commented on most members' reaction:

> "We got a few flutters from a few people, but we knew that, we expected it. It's one of those political decisions. I don't want to say 51%. You want to satisfy a lot more than that, which we did. I think it was positive to 80-90% of the people"

He also talked about the challenge of pleasing everyone:

> "I met a guy at a wedding last week, and he said to me, "Say, how's that equity thing coming?" And he kind of explained the whole situation. Well, he's 57 years old, he's not actively farming any more, he sold out, and he's got a small amount of equity at the co-op. He said to me, "You mean I have to die to get my equity?" and I said, "No, at age 78 you'll get it", and he said "You mean I have to wait another 20 years" and I said, "That's exactly right".

As this anecdote demonstrates, directors of this cooperative occasionally had to deliver unpopular messages to members. As they made decisions in the board room, they were well aware that they would need to communicate the rationale to friends and family members, and then report serious concerns back to the board room.

Board structure

Even extremely talented board members can't fulfill their potential if board activities aren't organized to effectively exchange information. Case study literature identifies numerous best practices to strengthen board decision-making (Lorsch, 1989). At this co-op, the board chair and CEO create the agenda together, and the board chair makes the final decision on the items that appear. Board members receive most of the materials prior to the meeting, and they're expected to bring their board notebooks, with the materials inserted, to every meeting. A member who is opening their packet at the board meeting may receive a comment from the chair. The board meets monthly for about four hours. Agendas include precise timing, and the president uses these guidelines to move along decision-making. During board meetings, he's sensitive to both the agenda and the flow of decision-making. He regularly asks the group if they'd like to vote, to gauge their readiness for a decision. If he senses an unresolved issue, he may suggest tabling a decision, or sending it back to a committee for more work.

After the management and committee reports, the remaining two hours of the board meeting are spent on current issues. These discussions present the board with the strongest opportunity during the board meeting to offer advice to management. The CEO and three of the top management team attend almost every meeting, where they sit at the board table and participate in the discussions. Some board members are consistently quiet, but most ask questions and contribute opinions. When board members discussed past difficult decisions, they didn't talk in terms of factions, close votes, or undue pressure. They described lengthy discussions that eventually led to a decision:

> "Once in awhile, somebody will gripe, boy these meetings last a long time, but when

> we're in a meeting, and we're discussing something, nobody ever says, it's getting late, and we need to get going. It's discussed until everybody's satisfied. And I think by the end of the discussion, the board's pretty much talked themselves into it, or talked themselves out of it."
>
> "Farmers are good at pointing out anything that can go wrong. So if you have 10 of them sitting around a table, they're willing to point out anything that can go wrong… So that's what they do – they point out any potential downside and make sure that it's well discussed. Risks are calculated risks."

The board creates an annual calendar to ensure that directors are aware of upcoming responsibilities, such as annual events like budget discussions, CEO compensation and strategic planning. The calendar also allows them to plan strategically for presentations from the department heads of operating units or functional areas. The CEO believes staff moral and commitment to the cooperative is improved by a strong relationship with board members:

> "It used to be only the [general] manager at the meetings. And here, the credit manager gives this report, someone else gives that report, and the board likes it. The staff feels much more connected with the co-op. It isn't the CEO and the board way off in the distance and then everybody else."

Staff members are also an important part of most board committee meetings. The CEO talked about the role that committees play in building the connections between staff and directors:

> "Committee meetings are places where board members interact with my division managers. The managers can discuss their ambitions, some things we'd like to see ahead."

The cooperative uses board committee meetings as a place for division managers to test ideas and discuss proposals in detail, before bringing them to the board. The board has several standing committees that correlate with the co-op's major operating units. They also have a finance committee, and use ad-hoc committees regularly. Committees don't meet every month, and they meet more often in the winter, when board members have fewer demands on their time. These meetings, which have agendas, but are run fairly informally, serve as a time for in depth discussion of issues. A board member commented on the relationship between these committee discussions and the board's final decisions:

> "You know there hasn't been anything brought up that's been so bad that it had to be re-drawn. I think management has a very good sense, maybe because the board's been so engaged, that something from management doesn't come from left field."

Representing Members on the Board

This cooperative's current board has its roots in member activism and a determination to build a strong and active board. In the mid-90s, the cooperative was growing very slowly. Some members felt that the board acted more like a social club than a governing board, going to all the right meetings, but not involved in the important decisions at the co-op. A group of members decided to put up a candidate who would push for growth and expanded services. Their candidate, now the current board chair, ousted the sitting board president. According to the board chair, “This got the board’s attention”, but the goal was change, not a revolution. The message from members was, “Let’s manage the co-op, let’s grow”.

As a new board member, he pushed the board to become involved in strategic planning, to write a mission statement, to develop a vision for the future. He asked that agendas be mailed ahead of the meeting, and helped institute a nominating committee. When he eventually became board chair a few years later, he worked with the CEO to make board meetings more productive, with tighter agendas, more oriented toward board decision-making. The members of the “old” board were replaced slowly, and mergers created opportunities to add experienced board members from the merger partners.

The director nomination process is designed to actively seek out high value prospective members. A nominating committee composed of 5 non-board members is elected by the members present at the co-op’s annual meeting. The CEO and board chair are ex-officio members of the committee, but the CEO makes it clear that he doesn’t influence the committee’s choices: “I don’t help pick the directors, definitely don’t do that.” The committee meets to review the co-op’s customer sales records, to identify the larger and most active customers. They also look at other factors, like geographic balance, age, and reputation in the community. Committee members approach the prospects personally to discuss possibly running for the board. After the discussions, the committee proposes a slate of candidates. In an investor owned firm, this list would probably go to the full board for approval. Since this is a cooperative, the next step is to prepare for an election. Co-op staff members visit each candidate’s farm where they take photos and prepare professionally-produced “meet the candidates” materials for mailing to each member. Voting is by mail, which precludes nominations from the floor at annual meetings. As one director said, they want to avoid situations where “one guy elbows another” to make an impulsive decision to run for the board. They may win a board seat because they’re well-liked, but be unprepared to serve on the board of a $200 million company.

In order to be effective advisors to the CEO, directors are well aware that they need to represent all customers, large and small, throughout the entire trade territory. Two board members commented on the dynamics within the board room:

> “Sometimes board members do tend to be the bigger farmers, just because larger farmers are the opinion leaders and the opinion leaders usually end up on the board. And that’s just kind of a natural progression. But, shoot, I’m a smaller farmer, non-conventional farmer if you will, so I think there’s definitely a voice there. I’ve never felt that the board disregarded smaller members in the co-op.”

> “For example, we’re looking at closing a convenience store in Augusta [name changed]. Well, the guy in Augusta he doesn’t want to close that store. But you know, I’m far enough away from it, I don’t know the local issues there. I look at it in more of a broad sense from our whole company, and it’s kind of a no-brainer. We need to close it. And that guy’s going through the same thing I did on the grain thing. So I think that’s a real strength we have, that we’re spread out enough. We try to keep it so that when something does come up in your area, you got a little better handle on it, in your area.”

Board members are well positioned to bring customer opinions into the board room, but it's clear from their comments that they understand the challenges of competing constituent interests. They need to represent their constituents in the board room, and communicate the firm's decisions to their friends and colleagues. These directors acknowledged the challenges of the task, but believed that this ability to balance interests, and stay focused on goals, was a major factor in their cooperative's success.

Conclusion

Directors of farm supply cooperatives are both owners of the business and consumers of the services. They are able to give good advice and monitor management with confidence because they are knowledgeable consumers of the firm's products and services. They have access to independent information on the firm's status in the marketplace, consumer preferences and loyalty. They understand the firm's competitive environment because they are approached (and may use) the cooperative's competitors. Directors share many characteristics with their fellow consumer members. They live in the same region, have a long term commitment to their location, have lived in the community for many years, follow the same seasonal calendar, and need similar supplies and services. They bring credible consumer information to the board room. The directors of this cooperative firm were able to give good advice and monitor management with confidence because they were knowledgeable consumers of the firm's products and services.

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