

# Legal Primer

## For Formation of Consumer-Owned Food Cooperatives

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## Table of Contents

1. Overview .....	4
2. Choosing a Business Structure.....	6
A. Tax Considerations .....	7
B. Financing Flexibility .....	11
C. Name of Entity .....	12
D. State of Incorporation.....	12
E. Not-for-Profit Organizations .....	12
3. Organization of Entity / Timing of Legal Organization .....	13
A. Incorporation or Organization.....	13
B. Articles of Organization or Incorporation.....	13
C. Personal Liability .....	14
D. Indemnification and Director & Officer (D&O) Insurance .....	15
E. Bylaws .....	16
1. Members .....	17
2. Board of Directors.....	18
3. Member Voting.....	19
4. Financial Issues .....	20
5. Raising Capital.....	22
6. Patronage Dividends .....	24
Appendix 1: Frequently Asked Questions .....	25
1. Timing of Incorporation.....	25
2. Types of Incorporation.....	26
3. Bylaws.....	29
4. Member Capitalization.....	30
Appendix 2: Articles of Incorporation Template.....	33
Appendix 3: Bylaw Template .....	37
BYLAW I: MEMBERSHIP .....	37
BYLAW II: MEETINGS OF MEMBERS .....	39
BYLAW III: DIRECTORS.....	41
BYLAW IV: OFFICERS .....	44
BYLAW V: INDEMNIFICATION AND INSURANCE .....	45
BYLAW VI: FINANCE .....	46
BYLAW VII: CONSENT .....	47
BYLAW VIII: MERGER OR CONSOLIDATION; DISSOLUTION .....	47
BYLAW IX: RESTRICTIONS ON SALES AND TRANSFERS .....	48
BYLAW X: FISCAL YEAR .....	48
BYLAW XI: AMMENDMENTS.....	48
Appendix 4: Duties and Responsibilities of Cooperative Board Members .....	49
Appendix 5: Sample Patronage Allocation Letter .....	55
Appendix 6: Further Reading.....	56
From the Food Co-op Initiative Web Site.....	56
Web links to other sites.....	56

# Legal Primer for the Formation Of Consumer-Owned Food Cooperatives

## 1. Overview

Interest in food cooperatives is growing, due both to increased interest in local, natural, and organic foods and to increased awareness of economic vulnerability in many of our communities. More and more communities want the products, stability and accountability that a cooperative can offer. Cooperatives are businesses owned by their members. This legal primer is designed to provide community groups with a basic resource for understanding the legal issues involved in starting a food co-op.

This legal primer was produced by CDS Consulting Co-op and Food Co-op Initiative. Joel Dahlgren of Black Dog Co-op Law authored the legal text and reviewed contributions from other sources. Thane Joyal of CDS-CC drafted major revisions for the September 2010 update. See these websites for more information: [www.cdsconsulting.coop](http://www.cdsconsulting.coop), [www.foodcoopinitiative.coop](http://www.foodcoopinitiative.coop) and [www.blackdogcooplaw.com](http://www.blackdogcooplaw.com).

Cooperative Development Services has created a development model--"Four Cornerstones in Three Stages"-- to help people work through the steps of organizing a successful food cooperative. The steps referred to in this legal primer relate to the Organizing Stage of the model. However, reference is also made to various legal and financial tasks that will come into play in the Implementation Stage and beyond. Within the four cornerstones of co-op development--Vision, Talent, Capital and Systems--this legal primer focuses on the development of legal systems. And, because of the crossover between legal structure and financial issues in a business, considerable time is also devoted to discussions of capitalization and taxes.

One of the first things you should do, in preparing to legally establish your cooperative, is to become familiar with the statutes of the state in which the cooperative will be organized. This may be the state in which the retail operation is located, or it may be another state. Competent legal advice should be sought at this early stage to help the group understand how to choose the right state statute for your organization and how the choice affects your organizing efforts. This statute will provide the parameters within which your cooperative is founded and operated. Familiarity with the applicable state cooperative statute cannot be stressed enough.

We also encourage you to incorporate or organize the cooperative sooner rather than later, because individuals may have personal liability exposure that will be mitigated or even eliminated by the "corporate" liability shield of the cooperative.

The following are terms used in describing capital structure in cooperatives. References to these terms are found throughout the text, and therefore we are introducing these terms at the beginning of this primer in order to acquaint you with them.

## *Definitions for Cooperatives*

- Allocated equity: Profits that have been allocated as equity credits to members' individual equity accounts, and are not taxable for either the co-op or the member.
- Capital reserve: Unallocated profits that are retained in the capital reserve of the cooperative, and are taxable.
- Retained earnings: Earnings that are not paid out to members as patronage refunds, and are retained in the co-op as allocated equity or in the capital reserve.
- Patron: A person who purchases products at the co-op, whether a member or not.
- Patronage dividend: The patronage dividend for a member includes both their patronage refund for the year and the allocated equity credits that were added to their equity account.
- Patronage refund: That portion of the patronage dividend (and it must be at least 20%) that is paid by check to a member at the end of the year in which the profit was made. This refund is not taxable to the individual.
- Common equity: The funds required to gain membership in the cooperative. These are called common shares or stock if the cooperative is formed on a stock basis, and not a membership basis. This equity is not a security since it is non-transferable, is redeemable only at the discretion of the board, and is redeemable only at face value.
- Preferred equity: Funds gained from a capital drive where additional equity is sold to members beyond that required for membership. These are called preferred shares or stock if the co-op is formed on a stock basis, and not a membership basis. These are securities since they yield dividends.
- Member loans: These are loans that can be offered members in a non-public offering. They are securities since they yield interest and may have time requirements on their redemption.
- Securities: Securities are transferable, pay a dividend or interest, and can increase or decrease in value. Within a cooperative, common equity is not a security, but preferred equity and member loans are. However, both of the latter can be exempt from being registered as securities under specific circumstances.

## 2. Choosing a Business Structure

Different states treat cooperative businesses differently. Most states do offer cooperative corporate business forms that are suitable for retail food cooperatives. However, a limited few states do not provide for any cooperative corporation. In those states, as a result, some retail food co-ops have chosen to use a not-for-profit corporation as their business form, while others have chosen to incorporate using another state's cooperative corporation law. Incorporating as a for profit corporation and operating as a co-op is another business form co-ops have used.

In choosing your business form, we recommend that you first carefully review the options provided by the state in which the retail store will operate. Because a cooperative form of business provides significant advantages, we assume the cooperative is your choice of business structure. However, there are different kinds of cooperatives and a variety of considerations in choosing where to incorporate. This primer includes a review of the basic business structures available to cooperatives because we want your choice of a business structure to be fully informed.

There are four basic structures available to retail food cooperatives. In general, choice of structure is driven by tax, financing, governance and corporate name considerations. The table below illustrates these considerations and compares four business structures.

<b>Entity Type</b>	<b>Tax</b>	<b>Financing Flexibility (4=most)</b>	<b>Cooperative Governance (4=most traditional)</b>	<b>Name of Entity</b>
Limited Cooperative Association (LCA) (new- style statute) Sub T	Limited taxation	4	3	Allows use of Co-op in Name.
Corporate Co-op (traditional statute) Sub T	Limited taxation	3	4	Allows use of Co-op in Name.
Corporation (including non-profit) Sub C	Double taxation	2	2	May Restrict use of Co-op in Name
LLC, Sub K	Single Taxation	1	1	May Restrict use of Co-op in Name

## A. Tax Considerations

Tax considerations are driven, in great part, by how the earnings of the four different corporate forms are distributed. The IRS classification of Sub T, Sub K and Sub C drive how taxes are paid in each of these organizational forms. "Sub" means Subchapter T, K or C of the Internal Revenue Code (IRC). The complexities related to these forms are more than is needed for this legal primer. Suffice it to say, that, generally speaking, Sub T is chosen for the co-op form, Sub C for the corporate form, and Sub K for the LLC form.

The chart above refers to limited, single and double taxation. Both cooperative forms (Sub T) reduce or limit tax liability for profits at both the co-op and member level. In the corporate Sub C form, profits are taxed at both the corporate level and at the shareholder level when dividends are distributed, hence double taxation. In the LLC Sub K, all profits are passed through to the owners, and taxed at the individual owner level, hence single taxation.

Subchapter T is thought to be particularly appropriate for co-ops since it is interpreted by courts to be consistent with three historic co-op standards: 1) limited returns on equity capital (8 to 10%); 2) democratic control, usually thought of as one member, one vote, and; 3) equitable allocation of earnings.

As a prelude to the tax discussion for co-ops, a distinction needs to be made between patrons and members. Patrons are people who purchase products at the co-op, whether they are members or not. Members are the owners of the cooperative, those people who have met membership criteria (usually based on purchasing membership equity and buying goods from the co-op). The co-op board can decide whether patronage dividends are made to all patrons and members, or whether the patronage dividends go only to members. Most co-ops provide patronage dividends to members exclusively. If a co-op were to make patronage dividends to all patrons, the co-op must keep records of all patrons by name. For purposes of this legal primer, we are assuming that patronage dividends go only to members.

Briefly the financial structures and tax implications of these business forms differ as follows:

**1. Limited Cooperative Association (LCA) (new-style statute) (IRC Sub T or Sub K):** In addition to being financed by member share purchases, member loans, bank loans, and retained earnings, this business form can also be financed by sale of shares to non-patrons, without a ceiling of 8% to 10% return on those shares. This is the primary reason for creation of this business form: to allow for significant capital to be raised from non-patrons. An LCA can choose to be taxed as either a corporation (Sub T) or a Limited Liability Partnership (Sub K), which will affect the tax treatment of the cooperative. Preferred shares in an LCA have no upper limit on their return, increasing the investment attractiveness to non-patron investors. If the LCA chooses a taxation form that allows it to take advantage of SubT, then when earnings are distributed, the board decides whether to pay dividends on preferred shares and at what levels. Non-patronage earnings, when distributed, are taxable corporate profits.

## Cooperative Tax Advantage (IRC Sub T):

**For the co-op:** The co-op does not pay tax on the income generated from sales to its members when that income is either returned in the form of patronage refunds or allocated on the co-op books as individual members' patronage earnings. By law, at least 20% of annual patronage dividends must be paid in cash to members as patronage refunds (if 20% is not distributed, none of the allocation can be deducted from the co-op's taxable income). That which is kept on the books as patronage earnings is redeemed only at some later time, and only if the co-op has excess capital. Retained patronage is redeemed according to a pre-established plan, and only at face value, i.e. there is no appreciation in its value. The co-op does pay tax on earnings that are not allocated, income from unidentified sales (not traceable to specific members) and income from non-patronage sources. The co-op pays tax on the earnings it distributes as dividends on preferred shares. It also must pay taxes on sales to members whose purchases are so small that it is not economically viable to send them patronage refund checks. Food cooperatives have the opportunity to allocate a high portion of their profits to members rather than to non-patron investors so as to minimize their taxable earnings, i.e. earnings taxable at the corporate rate. This is not normally done since investors will expect a return on their preferred shares.

**For the members:** Members whose purchases were for personal consumption will not owe taxes on their patronage refunds. This is due to the payment being viewed by taxing agencies as a refund of money spent for goods and services, where that money has already been taxed when it was received as wages, capital gains, etc. However, taxes ARE paid on interest on loans or any dividends received from preferred stock.

**2. Corporate Co-op (traditional statute) (IRC Sub T):** The business is financed by: a) sale of shares to members and member loans, b) bank loans, and c) retained earnings. Profits that are not retained in the business are refunded to members/patrons in proportion to their use of the cooperative (i.e. their annual \$\$ purchases at the co-op). Preferred shares typically have a limit on their annual return of between 8% and 10% as set by state laws.

Cooperative Tax Advantage (IRC Sub T): See discussion above, Same as for the new-style LCA co-op.

**3. Corporation For Profit Form (IRC Sub C):** This business form is financed by retained earnings, sale of shares, and loans. Profits not retained in the business are paid to shareholders in proportion to their investment. Unlike a co-op, shares are permitted to appreciate or depreciate in value. This is the typical corporate model.

### Tax Implications:

For the corporation: The corporation pays the corporate rate on profits.

For the shareholders: Shareholders pay the individual capital gains rates on dividends.

4. **Corporation Not For Profit Form (IRC Sub C):** This business form is generally financed in the same manner as the for-profit corporate form, but depending on additional organizational details may have significantly different tax considerations.

**5. Limited Liability Corporation (LLC) (IRC Sub K):** An LLC is financed by member investments, undistributed earnings and loans. Profits are returned to members in proportion to their investment or as per agreement.

### Tax Considerations:

For the LLC: The LLC pays no taxes.

For the members: All profits, even if kept in the LLC as undistributed earnings or as capital purchases, flow through to the individual members' tax statements and are taxable at the individual rate. Usually the LLC distributes at least enough cash to its owners to cover the increase in their personal taxes due to the LLC's profits. These profits may also be subject to self-employment tax.

This review of the five primary business structures shows that, in order to obtain the greatest tax benefits at least cost and in order to maximize the options for obtaining financing, formation as an LCA co-op under Sub T produces the greatest benefits, followed by the corporate co-op under Sub T. From the standpoint of taxes, the LLC under Sub K may be more efficient, but it is very complex and difficult to administer. We believe, therefore, that Sub T provides the most tax efficiency per dollar of cost, particularly because we assume that the lion's share of the income of your cooperative will be patronage sourced, and eligible for the Sub T tax deduction.

### Several Initial Steps

At the formation of your cooperative, several decisions will need to be made that have tax implications:

- **Establishing the Fiscal Year:** When incorporating any form of co-op, one of the first financial determinations the board needs to make is when the fiscal year ends. The ending of a fiscal year requires additional work, such as doing year-end inventory and accounting. Therefore, the board may want to choose a less busy time of the year for a year-end. With the winter holidays usually being the strongest sales period for a food co-op, the board may want to choose a year-end other than the calendar year-

end. Most food co-ops use a 52/53 week fiscal year, ending the fiscal year on the same day of the week each year to make inventory-taking more effective and to have more comparable financial data. Most co-ops end their fiscal years at the end of June. CoCoFiSt (Common Cooperative Financial Statements) deadlines and reports are designed around the preference for ending quarters at the end of June, September, December, and March even if the fiscal year end is not at the end of June. If the co-op plans on having its books audited, the board should also check with the auditor to see if she/he has a preference. Tax returns for a Sub T (IRS form 1120-C) are due 8 1/2 months after the end of the fiscal year.

- **IRS Form 3491:** After three years of doing business, the co-op should file form 3491 with the IRS in order to be exempt from filing a form 1099-PATR for each patronage refund provided a member after the three-year point. This can be done only if, in the first three years of operation, 85% of the gross receipts of the co-op were from retail sales for personal, living or family use (a requirement easily met by most co-ops). This exemption lasts from the first patronage refund after IRS approval, and ends after the first tax year when less than 70% of gross receipts are from personal, living or family use (dropping below 70% for a food co-op is not likely). Given the three-year lag before which such an exemption can be received, it is recommended that the co-op not issue any patronage allocations until after three years, and the IRS approval for the exemption. If the co-op wishes to allocate patronage in the first three years of operation, it will need to file 1099 forms for each of the patronage refunds and withhold money for tax purposes from the refunds. This will require significant accounting work.
- **Annual Retained Earnings:** A decision that the board will need to make early in the development of the co-op is whether to allocate all patronage earnings to members, or to use a portion of those earnings to build an unallocated capital reserve. The decision on how much to allocate to members or to use for building a reserve will depend on your expectations for redeeming equity. Allocated equity never has to be redeemed. By retaining allocated equity, co-ops can build a base of capital to use to strengthen and grow the business. We recommend never redeeming allocated retained equity. If you never plan to redeem equity, you should take the patronage deduction for all patronage sourced income, except for building a reserve for losses. Creating a reserve against which losses can be deducted is preferred to having no reserve, in which case losses must be allocated to members. The effect of this is to reduce each member's allocated equity. On the other hand, if your co-op will attempt to redeem allocated equity, you must create a larger unallocated capital reserve and carefully balance the amount of income you allocate compared to the income you do not allocate. The more quickly you intend to redeem allocated equity, the less of it you want on your books. Therefore, you should allocate only what you can redeem in a reasonable time. Any further allocation of patronage earnings would only weigh down the co-op and reduce the speed at which equity is redeemed. In these cases, it is preferable to pay more tax and create larger unallocated capital reserves to balance off the amount of income that is allocated.

## B. Financing Flexibility

Compared to corporations and LLC's, financing flexibility is greatest in the two co-op forms: the traditional corporate co-op, and the new-style LCA. The following are the differentiating factors between the two co-op forms:

- In the new-style LCA co-op, non-patron investors may become members, may serve on the board of directors and have voting rights. This cannot occur in the traditional co-op.
- There is no limit on the dividends that can be paid on capital stock in the new-style LCA co-op. In a traditional co-op, 8-10% is the typical limitation under state laws.

The LCA form of co-op was developed to allow cooperatives a means to obtain financing from non-patron investors **if they so choose**. But choosing the LCA form of co-op does not mean that a co-op **must** take advantage of this greater flexibility, only that it **may** take advantage of it. Most LCA co-ops do not have non-patron investors on their boards. However, allowing non-patron investors to be on the board and to receive above 8-10% return may be attractive to the co-op at some future point if the co-op needs outside non-bank financing.

There is one potential governance issue that should be considered if the LCA co-op is chosen. If the applicable law allows non-patron investors to be members and be on the board of directors, the co-op needs to be aware of how this will affect the governance and control of the cooperative. State statutes set up defaults and these vary by state. A default is an arithmetic minimum or maximum set by the state statute to protect the members of the cooperative. In the instance of the LCA cooperative, there are three defaults that must be considered:

- Director voting power: Patron directors normally have at least simple majority by statute. This means the non-patron directors cannot, by statute, have controlling voting power within the board of directors
- Member voting power: Patron members have simple majority voting power by statute. In addition, patron members vote as a block, so that even if there are only two members that attend a member meeting, they still hold majority voting power.
- Financial rights of patrons vs. non-patrons: The statutes place no limit on the return on investment in the cooperative.

To make this more complicated, in some states these defaults can be altered by the members. The state statute has to be reviewed to determine if this is possible, and for which defaults. If it is possible, then the members may alter the default to increase it or lower it, depending on the needs of the situation, and the preference of the members. Usually a default can only be changed in one direction. For example, patron members are allowed to give more voting power to non-patron members and non-patron directors, but not less. Also, patron members can give patrons the same dividend rate as non-patrons, and they can increase it beyond the standard 8% for everyone. Or they can say that non-patron members will receive 60% of the profits. In other

words, patron members within the LCA co-op can adjust the financial rights and voting rights within the cooperative to match their need to attract investors, guided by the ICA Cooperative Principles. Because the implementation of the default provisions is so variable, allowing nonpatron investors is controversial among cooperators. Cooperatives choosing this form of organizational financing would be well advised to carefully consider the pros and cons of their decision from a holistic and well informed perspective.

### **C. Name of Entity**

Most community groups wishing to form a retail food business want to include the word "cooperative" in their name. In considering the various business forms, only the traditional and LCA co-ops definitely allow the use of the term. Depending on the state statute, both the corporate form and the LLC form are likely to disallow the use of the term "cooperative" in the business's name.

### **D. State of Incorporation**

Generally speaking, a cooperative should incorporate in the state within which it resides. The primary reason relates to federal securities laws. Registering under federal securities laws is an expensive and time-consuming process. The cooperative should do everything in its power NOT to require registration. This is most easily done through a federal intra-state exemption, which is allowed if all of its member loans are from its state of incorporation. In the case of a co-op that resides close to another state, the co-op will only be able to obtain loans from members in one state. It should choose the state of incorporation based on where most of its members will reside, if it wishes to obtain member loans from them. Members who reside in a state that the co-op is not incorporated in will not be able to supply member loans.

### **E. Not-for-Profit Organizations**

Sometimes the community group wishing to form a retail food business believes they want to form as a not-for-profit. Some states may provide statutes for formation of non-profit co-ops, while others may provide for the formation of non-profit corporations. Other states provide neither alternative. Generally, non-profits operate for the public good, and no monetary gains may be returned to its members or investors. The choice for the founding group often comes down to either **for-profit** co-op status, which clearly allows for monetary gains to members, or **non-profit** co-op status where patronage refunds could be legally questionable. However, in the latter case the founding group may perceive some value in being a non-profit for reasons of community and/or government support which may seem to favor the "non-profit" moniker.

Our advice is to organize as a for-profit cooperative. Co-ops need earnings to finance their growth, similar to other businesses. Consequently, it seems that forming under a "for-profit" statute is more straightforward in its depiction of the co-op. Thus, we believe organizing "for profitability" more accurately portrays what a food cooperative is, and keeps the co-op from

entering a grey area as a non-profit where its operations could come under federal and state scrutiny.

Co-ops and organizing groups can sometimes find a fiscal agent or non-profit organization that can accept donations and grants for education and community development activities, and use those funds to support the cooperative's educational and community development activities.

### **3. Organization of Entity / Timing of Legal Organization**

#### **A. Incorporation or Organization**

Incorporation can be done for cooperatives, corporations and LLC's. However, incorporation means there are owners. In corporations, these are shareholders or stockholders. In order to reduce the likelihood of co-op member ownership being viewed as stocks or shares and therefore subject to securities regulations, we recommend that your organization form as a cooperative on a member basis, and not on an owner basis. This means that your members still own the cooperative, and hold 100% of the controlling power (unless they give voting rights to non-patron investors as mentioned earlier), but they aren't viewed by the IRS as individual owners with stocks or shares. Their ownership of the co-op occurs via purchases of common and preferred equity (instead of common and preferred shares or stocks).

#### **B. Articles of Organization or Incorporation**

To legally organize, articles of organization or incorporation must be filed with the Secretary of State of the state in which you are organizing the business. This action brings the organization into existence. If you are filing for a traditional corporate co-op or a corporation, you will be filing articles of incorporation. If you are filing for a LCA unincorporated co-op or an LLC, you will be filing articles of organization. Both types of articles are very similar. Since the term "articles of incorporation" is the best-known, this term is often used to refer to both types of articles.

The articles are public record, and are available to any citizen. The articles are normally simple, and just follow statutory criteria. The articles are more of a static document and are not amended often. The most common reasons for amending the articles are to increase the co-op's equity limits or to change the name of the business.

Articles of Organization or Incorporation include the following:

- Name
- Address
- Registered Agent: This may be required in some states. The agent is a resident of the state to whom the government can serve documents if required. This person does not have to be a board member. There are companies that provide this service (ex: CT Corp), but usually a person fills this role.
- First Board of Directors: Sometimes these people must be named, and sometimes not, depending on the state requirements.
- Minimum Number of Directors: A minimum number of directors is normally established in the articles. A typical company does not have less than 5 directors, and the bylaws then can establish the specific number.
- Capital Stock vs. Non-Stock: Check with your state statute to see if you have a choice. The unincorporated cooperative can be stock or non-stock, and the founding group must make a choice. We recommend non-stock, and thereby incorporating on a member basis as discussed above.
- Distribution of Earnings on Basis of Patronage: Many state statutes require that the articles include a statement that distribution of earnings will be made on the basis of patronage. Even if it is not a requirement of the statutes, you should add a provision like it for the purpose of creating a pre-existing obligation. (see example in Appendix 2)
- Altering Statutory Defaults: As mentioned earlier, defaults are minimums or maximums that are set in state statute to protect member interests. There may be a number of them that can be altered. Check with your state statute to determine what defaults can be altered. A state will impose its statutory default unless the founding group alters it in the articles or bylaws.

### **C. Personal Liability**

We recommend organizing your cooperative into a legal entity as soon as possible, after the formation of the founding group. Legal organization, like incorporation, is a very easy process. Early legal organization protects the founders from personal liability with what is normally termed a corporate shield. However, the founding board needs to be aware that the corporate shield is not an absolute protection, and the board must act responsibly in setting up the business. While the incidence of lawsuits against co-op directors or founding members is very low, there are two ways in which the corporate shield may not provide protection:

- **Going Around Corporate Shield:** On both a federal and state level, if securities laws are broken in the sale of securities or if certain tax statutes are not followed (such as payment of taxes), the courts can reach around the corporate shield and charge board members directly. In the case of liquidation, the holders of member loans and preferred stock can also go around the corporate shield to obtain recompense from directors. Therefore, fiscal responsibility is of the utmost importance in the operation of your cooperative.
- **Piercing the Corporate Veil:** This can occur if the corporate shield is weakened by inadequate procedures such as minutes not being taken at board meetings, board meetings not being held, or not allocating tax preparation to a preparer. When this occurs, the corporate shield may not protect directors from personal liability in areas well beyond those mentioned above. It is therefore very important to follow corporate formalities in order to maintain the corporate shield.

Another way to think of maintaining the strength of the corporate shield is that a cooperative, like any other form of business, is a fictional entity with similar constitutional rights to us. In effect, businesses are fictional persons. We must keep this entity in good standing or it will weaken and can die, disintegrating the corporate shield and opening directors to personal liability.

There are ways in which your directors can strengthen the corporate shield. When dealing with outside vendors or organizations, a director should always state that she/he is representing the cooperative. This makes it clear that the director is not acting on his/her own. Providing directors with business cards can be an easy way of formalizing this.

For more information on the risks and protections provided by board membership, please see the appendices for the article by Kathryn Sedo, [Duties and Responsibilities of Cooperative Board Members](#).

## **D. Indemnification and Director & Officer (D&O) Insurance**

Usually state statutes require a cooperative to indemnify their board of directors, and even if not required, we recommend that your bylaws provide for director indemnification. Indemnification means that either the co-op or their D&O insurance company will cover legal and certain other expenses that could be incurred by a cooperative or director in the course of defending themselves against allegations of misconduct or negligence. D&O insurance may indemnify both directors and employees for their actions if the insurance covers employees as well. The cooperative should be aware that indemnification is a reimbursement for expenses paid, not a direct payment of the expenses. So, the co-op (or a director) must pay the legal fees before being reimbursed from the insurance company.

## **E. Bylaws**

Bylaws can be viewed as the contract between the board and the membership concerning how the organization will be run. Bylaws are usually not a legal requirement. However, you will find that many businesses do have bylaws in addition, of course, to their articles of incorporation or organization on file with the state. Articles are generally very short, because we don't want a lot of confidential information in a document that is public and can be obtained by anyone. The bylaws are considered for members' eyes only and are a confidential membership document. It can also be far easier to draft and amend bylaws than articles. Sometimes bylaws require a lower approval level (simple majority vs. two-thirds). And, more importantly, bylaw amendments do not need to be filed at a Secretary of State's office, as do amendments to the articles.

Bylaws allocate governance responsibilities. Again, state statutory defaults play a role here. Typically a statute will set a minimum, and allow adjustment upward. For example, the statute may set quorum for member meetings at a low level, and it can be increased in the bylaws, but not decreased. In the case of the size of the board of directors, the statute may say no less than three, and the cooperative can apply either a range or a specific number in the bylaws.

By state statute, members' power is limited to specific areas. These normally include:

- Members elect or remove directors.
- Members vote on dissolution, merger, consolidation or sale of all or substantially all assets.
- Members are usually permitted to request records and minutes from the cooperative, but sometimes this must be for a proper purpose.
- Members can petition the Board to call a special meeting of the Members; typically 25% of the members must sign the petition.

Members should be educated that these are the limits of their power. Their control over the cooperative is through their election of the board of directors, and therefore they should be urged to participate in board elections.

However, there are also defaults in certain state statutes as they relate to member voting power. These defaults could be changed to allow more member power, but this is not often done, and we do not recommend it. The Board of Directors is elected to give leadership to the cooperative and we believe members' best role is to control who is elected into these leadership positions.

Notwithstanding the above comments, governance rights can be carved up in any number of ways. For example, members could have the responsibility of defining product selection criteria (usually a management responsibility), or the bylaws could require the creation of a member committee to interview and hire a general manager (usually the board's responsibility). The

possibilities are endless but we are not recommending modifications to the usual approach. The basic philosophy that most state statutes follow is to place almost all of the governing rights in the board of directors, which means that members' participation in the process of electing directors is vitally important. When governance rights are carved up among membership and the board, three common areas where modifications are made include:

- Buying and selling assets (setting a limit on what the board can spend)
- Borrowing money (limiting what the board can borrow)
- Redeeming allocated equity (such as a requirement to redeem equity at a member's death)

A universal approach to writing bylaws does not exist, because each state statute is different, and must be separately evaluated. Having said that, if you compare the bylaws of cooperatives across the country, you are likely to see common threads running through many of them. Some of these common threads that you should consider addressing are included in the list below. However, a close review of your state statute is still highly recommended. Many of the following may require altering defaults in state statutes. State statutes normally allow more freedom in altering defaults that apply to the board of directors, than to the membership.

## **1. Members**

- a. Membership Criteria: what is expected from members (for example, they must patronize the co-op, must live in the area). These criteria can be more restrictive, such as saying no felons, but they cannot cross a protective class.
- b. Termination of Membership: under what circumstances membership privileges are lost.
  - i. Automatic Termination: This usually occurs when the member is no longer doing business at the cooperative (the bylaws normally state a length of time before this takes effect), or the member moves. This termination is normally just a board action.
  - ii. Discretionary Termination: This is done on the basis of parameters set within the bylaws. For example, the bylaws can say that all members must be approved or disapproved by the Board, or that members must behave in accordance with the norms of the community where the cooperative is organized. This leaves discretion to the board as to whether a membership should be terminated. Discretionary terminations can occur without a hearing before the Board, but the bylaws could state an option for an open meeting.

## 2. Board of Directors

- a. **Size of Board:** number of directors or a number range. We recommend selecting either seven or nine as the number of directors.
- b. **Term Limits:** number of terms directors may serve. There is normally no default on this in state statutes.
- c. **Staggered Terms:** staggered terms are set for board directors so that the board does not turn over completely at each annual meeting.
- d. **Frequency of Board Meetings:** Monthly meetings are the norm.
- e. **Requirements of Officers:** The attached sample bylaws lay out the normal responsibilities of officers of the board. However these can be altered some. For example a Secretary or Treasurer could preside over meetings. And the number of officers required to sign a note or contract should be included in the bylaws.
- f. **Notice Requirement for Board Meetings:** State statutes often say that notice of a board meeting must occur a certain number of days before the meeting. The bylaws can alter the number of days or remove this entirely, so that there is no notice requirement.
- g. **Removal of Directors by the Board:** Bylaws should include a provision that allows a super-majority of the board to terminate a director for cause. Many boards adopt a code of conduct policy that sets behavior standards which would be used to terminate a director who violates the code of conduct. The bylaws can also include a provision for dismissal of a board member under specific circumstances (such as missing 3 consecutive or 4 total board meetings in a year).
- h. **Use of Advisory Directors:** The bylaws may want to allow for advisory directors who are from the membership or who are professionals in the community whose expertise is important to the Board.
- i. **Member Voting Districts:** Most food co-ops do not have member voting districts, where each district elects a board member, and we don't recommend it.
- j. **Dishonesty Insurance:** Dishonesty insurance or bonding can be required for those that handle money, whether they are directors or co-op employees. However, cost may restrict a new cooperative from purchasing this insurance. In the absence of insurance, we recommend that the Board require two signatures on a check. These concerns can also be addressed in board policy.
- k. **Unqualified Annual Audit:** An audit is an option, and the bylaws can require it. Sometimes a bank will impose an annual audit as a prerequisite for obtaining a loan.

l. Nominating Committee: Normally this committee is formed from the board, but members sometimes elect a board nominating committee at the same time that they elect the board of directors. This gives the members more power by controlling who is nominating director candidates.

m. Per Diem and Expense Limitations for Directors: Some bylaws state that the directors receive no compensation, whereas others allow the board to establish its own compensation. If compensation is allowed, the amount is usually defined by a policy rather than the bylaws.

n. Membership of Non-Patrons (in LCA Co-ops): If the cooperative wishes to take advantage of non-patron investment in the LCA cooperative, the bylaws must first grant membership to the non-patrons.

o. Non-Patron Directors' Control in LCA Cooperatives: The bylaws can change the defaults set by state statute in order to adjust the financial and voting rights of patrons and non-patrons at the member and board level (as per the earlier discussion).

p. Board Power to Amend Bylaws: Under the required notice provisions, the bylaws may be able to give the board power to amend bylaws. Some state statutes say the board cannot amend bylaws, but usually the statute is silent about the role of the board. If the statute is silent, the bylaws can grant the board the right to amend bylaws. If this is chosen, we recommend that the bylaws include the requirement that the board announces any bylaw change that it has made at the following annual meeting. Some co-op bylaws require that the members approve of any bylaw changes made by the board during the year.

### **3. Member Voting**

a. Absentee Ballots for Election of Directors: If absentee ballots are preferred, the state statute should be consulted, since the provision for absentee ballots may have to be included in the bylaws. Our suggested wording is "Absentee ballots shall be used for removing directors, and may be used for electing directors." The option for electronic ballot may also have to be stated in the bylaws. For the election or removal of officers, it is best not to rely on a special meeting of members, since quorum in a low turn-out can be misused by a faction of people wishing to control the co-op.

b. Minimum Period of Notice for Member Meetings: Check the state statute for this. The statute normally sets a default minimum, and the bylaws may set a longer period.

c. **Parliamentary Rules:** The rules for conduct of the member and board meetings are normally not in the statute. The bylaws can establish parliamentary rules for the meetings, such as Robert's Rules of Order. In the absence of a specific requirement in the bylaws, the board of directors, or perhaps the president or chairman alone, can determine what rules will govern.

#### **4. Financial Issues**

a. **Annual audit:** The state statute normally does not require an audit, but the cooperative may want to include the preparation of an unqualified annual audit in the bylaws.

b. **Limits on Handling Losses:** Often, bylaws state that losses must be applied against the capital reserve of the cooperative, and then subsequently against members' equity accounts. But some bylaws allow the capital reserve to go negative, so that members' equity accounts are not affected. The cooperative needs to decide how it wants to handle this.

c. **Redemption of Equity:** This should always be at the discretion of the board. There should be NO requirement of the board to ever redeem equity, and this should be stated in the bylaws. Required redemption of equity could put the co-op at financial risk, or subject it to onerous record-keeping.

d. **Minimum Cash Refund Paid to Patrons:** By federal law, 20% is the minimum percent of the patronage dividend that must be paid in cash to patrons as patronage refunds. Increasing this does not need to be in the bylaws, but can be a board policy.

e. **De Minimus on Which Patronage Refunds are Paid:** This is the minimum amount that the board will write a check for, or the minimum amount of the distribution to a member. Often, the bylaws state a de minimus of \$1, so that no checks for patronage refund distribution will be written for less than that amount.

f. **Pre-Existing Obligation:** Federal law states that there is a pre-existing obligation that patronage earnings must be distributed on the basis of patronage. This provision must be in the bylaws (or in the articles if there are no bylaws).

g. **Losing Contact with Members:** It is nearly impossible to keep track of every member because many move for employment or other reasons. The co-op is not under any obligation to maintain a current address for each member. That is the responsibility of the member. Many addresses go invalid each year. A "No Address" bylaw allows the board to determine when it is satisfied that the member cannot be found, in which case any allocated or contributed equity that has not been called for payment previously may be redesignated to the co-op's capital reserve. Reassignment keeps the co-op's records current, and allows the board to

focus its attention on the allocated equity of members who are known, and for whom the board may develop redemption policies. The "No Address" bylaw allows the board to direct its attention to the true "obligation," allowing the board to make comprehensive plans for the proper management of equity. However, please be aware that the allocated equity reassigned to the unallocated capital reserve is potentially taxable. Check with your tax accountant to determine the tax impact. Also be aware that cooperatives are subject to unclaimed property law once the co-op cuts a check. If the owner of the patronage refund cannot be found, the amount becomes unclaimed property and must be turned over to the state. The unclaimed property statute requires an annual report to be filed with the state. It is recommended to do this even if the co-op has nothing to report, because it establishes a starting point for the statute of limitations in case a claim is made at a later date.

h. Consent: This is one of the requirements of a Subchapter T, which came into existence in the early 1960's. There had historically been much controversy and confusion about whether or not the co-op and/or its members should pay tax. It has been established that patronage allocations made by consumer-owned co-ops are not taxable to the co-op or to the member. However, there could be income passed through to the member that is taxable, although this is not a normal occurrence. IRS rules require that the member must consent to submitting income for taxation if it is taxable. This consent can occur in any of the following manners:

i. Include a Consent Provision in the Bylaws: Typically the co-op is expected to send out the bylaws to each new member, and include a reference (such as in a letter) that specifically points to the consent provision.

ii. Membership Agreement: The co-op can provide membership agreements to new members that must be signed to activate their membership. This agreement includes the consent provision.

iii. Check: On the check that is sent out to the member, a little statement can appear close to where they endorse the check that says they are consenting to report this income if it is taxable

i. Building Unallocated Capital Reserves: Allocated capital is that portion of the profit that is placed under members' names as allocated equity credits in their equity accounts, after the cash portion of the patronage refunds has been made to them. Unallocated capital are those retained earnings which are put into the capital reserve for use by the co-op. A statement can be made in the bylaws that empowers the board to determine how much profit to put into the capital reserve.

j. Distributions of Equity in Conversions or Liquidations: Although rare, a food cooperative may be converted to another form of business structure, such as an

LLC. When this conversion happens, or a liquidation occurs, the question becomes how to allocate proceeds after debt has been paid. A provision can be included in the bylaws to either donate the excess to a 501c3 non-profit organization, or to allocate it to members. We recommend that a 501c3 option be considered in the case of a conversion, but that proceeds should go to members in the case of a liquidation.

## 5. Raising Capital

a. Cooperative Member Interests: Generally, cooperative member interests are securities. In a cooperative, the members have received equity either in exchange for having paid for shares, or for money they have earned from the co-op that has been reinvested in the co-op. However, in some circumstances, properly structured membership interests in cooperatives may not be securities, allowing solicitation of membership without the impact of securities registration. The benefit of a cooperative's equity not being considered securities is that the co-op does not have to incur the onerous cost of security registration. It is important to note that preferred stock/equity and, with only a limited exception, members' loans are securities.

b. Registration and Exemption of Securities: Preferred stock/equity, member loans and any common stock that is considered a security must either be registered or be exempt from registration under both federal and applicable state securities laws. Below are several of the more commonly used federal exemptions for consumer-owned food co-ops:

i. Intrastate Federal Exemption: The intrastate exemption exempts, from federal securities regulation, offers and sales of securities that are offered and sold only to persons in one state. In general, to qualify for safe harbor, the cooperative must be organized, doing business, and making offers and sales of its securities in the same state; the offers and sales can only be made in that state and cannot be made to any resident of another state within six months of the offering; and any transfers of the securities within nine months of the offering must be made only to residents of that state. The securities must be registered or exempt under the applicable state securities laws. Some states have a self-executing exemption from registration (meaning you do not have to do anything to qualify) for co-op securities, especially the large agricultural states. However, this exemption may be limited to only common stock or to particular types of cooperatives. You will need to review your state statute to determine if your cooperative qualifies for this or any other state exemption before moving forward with the intrastate federal exemption.

ii. Non-Public Offering: This exemption is available when the offering is truly a private offering. In a cooperative, one type of private offering is by

making offers and sales only to current members that do not involve any general solicitation or advertising. The longer that the members have been members, the stronger the argument in favor of a non-public offering. This offering cannot be made to potential members as part of their joining the cooperative. Many states have existing member exemptions. You will need to review the specific details of your offering with respect to federal securities laws, as well as state statutes in all states where you have members, to determine if this exemption is available to you.

iii. Rule 506 Offering: Another type of non-public offering is a "Rule 506" private offering. In general, sales can be made to an unlimited number of accredited investors (as defined in the regulations) and up to 35 nonaccredited investors; there can be no general solicitation or general advertising; the securities cannot be resold unless registered or otherwise exempt; and the cooperative must satisfy certain disclosure requirements. Securities sold in accordance with Rule 506 are considered federal covered securities and are exempt from state registration requirements.

It is important to note that there are also registration requirements, and possible exemptions from those requirements, for the individuals that actually offer and sell the securities. Typically directors and officers of a cooperative are exempt from those requirements. However, specific circumstances and applicable law should be examined before anyone makes offers or sales.

c. Disclosure Issues for Securities: You must disclose all of the material terms of the equity or debt regarding the co-op and its business and related risks to prospective purchasers of the securities, regardless as to whether the securities are exempt from federal or state registration. All disclosures related to the offer or sale of a security are subject to the anti-fraud provisions of the securities laws, which means that the disclosure cannot contain any untrue or misleading statement or omit any statement which makes the information untrue or misleading. The offering documents for an investment include:

i. Confidential Information Statement: this is like a prospectus, and it addresses all material terms and risks of the securities, the cooperative, and the terms of the offering.

ii. Subscription Agreement: This is an agreement to purchase a certain amount of equity, or loan a certain amount of money through a member loan.

iii. Certificate of Indebtedness or Certificate of Membership Interest: This is the official document issued by the cooperative that details the member loan or the equity purchase.

The process is that once a member has reviewed the confidential information statement, and decides to move forward with the investment, she/he signs the subscription agreement which is then brought before the co-op board for approval. Upon approval, the co-op issues a certificate of indebtedness (for a loan) or preferred equity/ stock certificates (for an equity purchase).

d. **Additional Equity:** Oftentimes the founders of new cooperatives do not realize the amount of financing that will be required to start up and operate a food cooperative. Due to its limitation on transfer and its redemption at face value, common equity is used simply to purchase membership and does not yield a significant amount of equity. Therefore, the cooperative may need member loans, a bank loan or preferred equity to obtain adequate financing.

e. **Member Loan Programs:** A member loan program is a vehicle for obtaining financing in addition to a bank loan. A cooperative can obtain a bank loan (secured) and then obtain any additional financing it needs through a member loan program (unsecured). This financing package could also include a preferred equity program. However, members are often more apt to provide loans where there will be fixed obligations of paying interest and paying principal, and a relatively more "secure" investment. In the case of a liquidation, the secured loans are paid first, followed by the unsecured loans, then the preferred equity, and finally the common equity. As noted above, member loan programs, except in very limited circumstances, are securities offerings and must comply with the registration or exemption requirements of federal and applicable state securities laws.

## **6. Patronage Dividends**

a. **Qualified Written Notices of Allocation:** Each year, these notices must be sent to individual members, notifying them of their patronage refunds and/or allocation of equity credits, if there are any. The letter to the member must have particular content (see Appendix 5.) The cooperative must do this to qualify for a tax deduction on this allocation, and it must be done at the time of the allocation. If these letters are not provided to members, the IRS and state agencies may consider these funds to be taxable retained earnings.

b. **Building Capital Reserves:** It is important for the cooperative to retain earnings and build a capital reserve. If there is a year with a loss, this allows the loss to be deducted from the reserve. Then it does not have to be broken into individual amounts and allocated to each member's equity account as would be required if there were no, or an inadequate, capital reserve.

c. **1099 -PATR:** As mentioned earlier, the filing of IRS form 3491 after three years of operation exempts the cooperative from filing 1099-PATR forms for each of its members when patronage refunds are made. Normally a 1099-PATR

must be filed when an individual refund amounts to \$10 or more. However, form 3491 frees consumer cooperatives of this obligation if they are primarily engaged in the retail sale of goods and services that are generally for personal living or family use of members. Natural food cooperatives fit this definition.

## **Appendix 1: Frequently Asked Questions**

### **(Concerning the Legalities of Co-op Formation)**

#### **1. Timing of Incorporation**

[NOTE: for more information on incorporation, see the third section of the Legal Primer, **Organization of Entity/Timing of Legal Organization**]

**A. At what stage of the development process should a group incorporate?** When a group of people believes that a cooperative can be a successful business enterprise, and wishes to evaluate their opinion further by pursuing feasibility analysis. Incorporation is a simple process in most states and the filing usually costs less than \$200. The filing can occur without legal advice. Filing affords founding members liability protection, and lends legitimacy to the process in the eyes of potential lenders and other potential member/owners. Articles of incorporation are filed at the time of incorporation. Bylaws are not usually required by law, but if they are to be completed, this normally occurs during or just after incorporation.

**B. What development events/activities/decisions should precede incorporation?** The one event that should precede incorporation is the formation of the above-mentioned group of committed people who wish to start the cooperative venture. This group becomes the steering committee for the development of the cooperative. Once the cooperative is formed, a board is chosen from among the members, and the board takes on the responsibility of development. The board may choose to keep this responsibility for itself or delegate it to a subset of members that

will continue as the steering committee. Due to the small number of members at the point of incorporation, the board and steering committee may be interchangeable.

**C. To what extent does feasibility need to be determined before incorporation?** Feasibility does not need to be determined before incorporation.

**D. When should a co-op decide the value of a membership?** The decision should be made when the Board of Directors has determined the amount of equity the cooperative needs, the proportion of that equity that will be raised from purchases of memberships, and the approximate number of members who are likely to join the cooperative. However, purchases of memberships should not be relied on to capitalize the co-op. This reliance should be placed primarily on member loans and bank loans. Otherwise, the membership values could be overpriced.

**Should feasibility be determined before the decision on the amount of member equity is made?** It may not be until after the feasibility study is prepared that any final determinations can be made about the proportion of equity that will be raised from memberships and the number of members who will join the cooperative. But, if the Board determines that a membership equity value should be established earlier, the Board should attempt to establish a value that covers part of the capitalization of the business without overpricing the memberships. This should be an amount that will create a sense of ownership among members. Whatever the amount, the Board needs either to be comfortable with it, or the Board must realize that it may have to be changed later. In the latter case, member education and support will be needed.

**E. How should a group handle funds and fundraising prior to incorporation? Donations, grants, investments from members? Bank accounts, collection and disbursement of money?** A group should not do any of the above prior to incorporation. The only monetary expenditure required before incorporation is the filing fee for the articles of incorporation, and the founding group may have to finance this fee. Before or after incorporation, the founding group may wish to align with an organization that can act as their fiscal agent for the receipt of grants, donations, etc. Such alignment with a 501c3 organization will allow access to funds not disseminated to individuals or businesses, and will allow the donors to write off their gifts as charitable contributions.

**F. When should the original articles of incorporation be reviewed/ revised, and what events would trigger review/revision? (e.g. before the transition from steering committee to board, before equity is raised, after the business plan is completed?)** The original articles of incorporation should be drafted broadly enough to avoid having to amend them, until circumstances have caused the cooperative to grow beyond them and they are obsolete, or because changes in the law make amendment of the articles of incorporation necessary.

## **2. Types of Incorporation**

[NOTE: for more detail on incorporation, see the second section of the legal primer, entitled **Choosing a Business Structure.**]

**A. What are the different options for incorporation for a consumer cooperative?** There are four basic options:

1. Limited Cooperative Association (LCA) new “unincorporated” cooperative taxed under either IRC Sub T or K,
2. Traditional “corporate” cooperative taxed under IRC Sub T,
3. Corporation (for profit or not for profit form) generally taxed under IRC Sub C although can be taxed as co-op under Sub-T, but state law may prohibit use of the word “co-op, cooperative, etc.” to co-ops formed under corporation statutes, or
4. Limited liability company (LLC) generally taxed under IRC Sub K, although can be taxed as co-op under Sub-T, but state law probably will limit use of the word “co-op, cooperative, etc.” to co-ops formed under corporation statutes.

**B. What should a group consider in making the decision?** A retail food cooperative should wherever possible choose a business form that allows it to take advantage of the preferential tax treatment for cooperatives in IRC Sub T. In addition, organizers should consider their financing needs, whether their business form will allow use of the term “cooperative” in the corporate name, and how the cooperative will be governed. The Cooperative Principles established by the International Cooperative Alliance provide excellent guidance for cooperators in making decisions about governance and control.

**C. What are the advantages of the new "unincorporated" LCA cooperative statutes?** Financing flexibility is the hallmark of the unincorporated co-op statutes. They typically allow: 1) the payment of something higher than an 8% dividend on non-voting equity capital; 2) non-patron members to invest in the cooperative and to participate in governance, and 3) non-patron directors on the Board of Directors. None of these are required by the statute, rather the statute permits the financial and governance rights to be created if that flexibility is necessary to attract capital from non-patron investors.

**What are the disadvantages?** The co-op must remember to file Federal Form 8832 (entitled 'Entry Classification Election') within 75 days of the incorporation of the co-op, if it is forming under the new co-op statutes (not required for filings under old co-op statutes) in order to ensure the co-op is taxed using Subchapter T. We recommend that the form be filed at the same time that application is made for a Federal Employer Identification Number using Form SS-4. In addition, the co-op should review and document its decisions concerning the use of non-patron investor funding, particularly the circumstances and conditions that would apply to participation of non-patron investors in the cooperative’s governance.

**D. If the cooperative statute in a particular state is not conducive to consumer cooperatives, which states are preferable? Why?** Wyoming, Minnesota, Wisconsin, Iowa, Tennessee, Utah, and Nebraska all have new “unincorporated” LCA co-op statutes. Minnesota, Wisconsin and Iowa are the most flexible because they do not limit the use of a cooperative to the processing of agricultural commodities. However, there are ramifications for incorporating under another state's co-op statute. Please see Section 4 on Member Capitalization in the FAQ's for an explanation of these ramifications.

**E. When (if ever) would a non-profit structure (including seeking 501c3 status from the IRS) be used for a consumer food cooperative? Why?** [NOTE: See 2.E in the Legal Primer for more discussion of this topic.] First, a little background on co-ops. Co-ops are sometimes thought to be non-profits, but, in the eyes of the IRS, a cooperative is a for-profit business organization that is owned by its users. One of the key differences between cooperatives and

other for-profit organizations is how the earnings are distributed. In a cooperative, earnings are distributed to the users or patrons in the form of patronage refunds on the basis of use. In an investor-owned business, the earnings are distributed in the form of dividends on the basis of investment rather than use.

Federal law allows organizations to apply for and receive an exemption from income taxes by establishing themselves as non-profits with 501c tax-exempt status, but these organizations must operate for the benefit of the public rather than individual members or investors, and no monetary gains are returned to them. A non-profit with 501c status is not a recommended structure for a business, and will likely not be allowed under IRS rules.

The situation at the state level becomes more complicated. Some states allow non-profit cooperative status and some do not. Check with your state to determine if this is an option for your co-op. But choosing non-profit status means that there is no monetary gain for members. In fact, state laws typically prohibit non-profit corporations from distributing pecuniary gain to members. Some food co-ops that have formed under non-profit statutes use the philosophy that a patronage refund is a reduction in cost rather than a pecuniary gain to members. This is a "stretch" that may or may not be legally justifiable if put to the test in a court of law. A patronage refund is a financial or pecuniary gain because it represents profit from the business, a profit the members would not enjoy if the cooperative were not in existence.

Another issue under state law is that non-profit corporations may be prohibited from distributing to members the proceeds remaining after a liquidation. That state statute may require, for example, the remaining proceeds to be distributed to a charity or other non-profit organization. This may not match the expectation of the members.

If state law allows non-profit co-op status, the co-op's founding group will have to choose between 1) for-profit co-op status which clearly allows for monetary gain to members, or 2) non-profit co-op status where patronage refunds would be legally questionable, but the founding group perceives some value in being a non-profit for reasons of community and/or government support. Our advice is to organize as a for-profit cooperative because it is a more accurate portrayal of the co-op's business objectives and purpose.

**F. How should the cooperative be organized?** Cooperatives can be organized with stock or on a membership basis without capital stock. There are two reasons to form on a membership basis rather than a stock basis: 1) the administrative and accounting effort to keep track of stock is significant, and 2) the use of the word "stock" implies a security even if it does not operate as such within a cooperative. When a co-op is formed on a membership basis, membership interests or units or voting "stock" are not securities. Membership interests purchased by members do not appreciate in value, do not pay dividends, and are redeemable at face value, if at all, at the sole discretion of the Board of Directors. Therefore membership interests do not meet the definition of securities. For the sake of clarity and accounting ease, we recommend that cooperatives form on a membership basis and not a stock basis. However, many food cooperatives organize with stock because their members want to own a share of stock, a more recognizable ownership form than a membership interest or unit. In that case, co-ops need to be very clear in their bylaws about the factors that exclude their stock from designation as a security: no appreciation, no dividends, face-value redemption at discretion of the Board.

### 3. Bylaws

[NOTE: for more information on bylaws see 3.E in the Legal Primer]

**A. What are guidelines and rules of thumb for bylaws?** Whereas the articles of incorporation must be filed to create the business organization, the bylaws are usually thought of as a contract among the members, the Board of Directors and the co-op that address governance and financial rights. The bylaws are not filed, and are considered confidential private property of the organization. The most important areas addressed in the bylaws are (1) membership qualifications, member rights and responsibilities, and termination of membership; (2) establishing quorums; (3) frequency and timing of annual meetings, (4) use of proxies and/or absentee ballots; (5) officer positions and responsibilities; (6) pre-existing obligation, as required by the Federal tax law for co-ops, that patronage earnings be distributed to patrons in proportion to their use of the co-op; (7) indemnification of the Board of Directors by the Co-op, whereby the co-op may have to indemnify a director or the board out of its own cash reserves, or by D&O insurance that is purchased by the co-op; (8) what happens to equity if the co-op cannot locate equity holders; and (9) amendments of bylaws. State law will vary on many of these issues, so the state statute where your co-op will be formed should always be consulted in conjunction with drafting of the bylaws.

**B. What doesn't have to be addressed in a set of beginning bylaws? How specific do they need to be?** First, bylaws are usually not required by law. The statute fills in quite well if bylaws either do not exist or are silent about a specific issue. That said, co-ops almost always have a "pre-existing" obligation that requires patronage earnings to be distributed on the basis of patronage, whether or not there are bylaws. If there are no bylaws, the pre-existing obligation should be included in the articles of incorporation. As to specificity, bylaws should give direction to the Board of Directors, and authorize the Board of Directors to establish policies for guidance of the Cooperative.

**C. Is it a best practice to have members approve changes in bylaws? If so, how does that work in the early inception stage before there are members or many members?** Once the cooperative is incorporated, the directors represent the minimum number of co-op members who may approve bylaw amendments. It's difficult to imagine a time when the co-op would not have more members than just directors to vote on "member" issues. As the cooperative membership grows, there are varying views on whether the board or members should have the power to make bylaw changes. The members always have "trump power" over the board through their power to elect or remove directors. If the board is given the power to make bylaw amendments, the board must nonetheless recognize that, as in any democratic institution, governance is always consented to by the governed. Therefore, making decisions that are in line with the members' intent is important. Otherwise board members can risk removal from office. But, more importantly, if board actions are not aligned with members' interests and values, the cooperative will be weakened.

**D. Should members approve the initial capital structure of the co-op and any future changes? (e.g. member share requirements, etc.)** It is incumbent upon the Board to make good judgments about capital structure. This structure is normally not submitted to member review. However, it is critical that the board educate members as to how the capital structure or change is in the best interest of the co-op and therefore its members. If the members don't

understand or support the capital structure, it is not likely that it will raise the necessary capital. See the response to C above regarding the risks that directors should always keep in mind.

**E. What are appropriate decisions for members to make in a consumer co-op?** Typically liquidation, dissolution, merger, consolidation and election of directors are the decisions that members make. Everything else is decided by the Board of Directors. This does not mean that other matters cannot be taken before the membership, but submitting issues for member approval can be very cumbersome and expensive, and normally directors are elected to make these decisions. The most important decisions made by members are the election of directors every year at the annual meeting.

While democracy and member control are important values, it is also important to protect the co-op from a minority of members with a particular agenda that may not be in the best interest of the members or the co-op as a whole. The board is legally bound to consider the whole co-op and all its members. A small group of members does not have such an obligation and there have been cases where a few members have used broad member decision-making rights to the detriment of the co-op. We recommend limiting issues members decide while emphasizing transparency and strong linkages between the board and members.

**F. Can households, businesses and other entities be patron members?** Yes, they can be patron members. Within each membership, there would then be multiple patrons. A multi-party membership entitles a co-op to a deduction for every patron. If patrons' purchases are tracked separately, every patron would need to supply his/her social security number so that tax deductions can be made for the patron's purchases. A multi-party membership can also be a way of increasing sales at the co-op. For business and household memberships, we recommend that only one person be the designated vote-holder and contact person. While a business is self-defining, you will need to define the meaning of the term, "household." A household could be defined as "related people living in the same housing unit," or it could be more broadly defined as "people living in the same housing unit and sharing meals." If one person of a business or household engages in conduct meriting termination of the membership, we recommend that the membership be canceled, and the remaining people be given the option of individual memberships or a redefined group membership.

## **4. Member Capitalization**

**A. How should start-up food co-ops deal with securities regulation issues in their efforts to raise member capital (in equity or member loans)?** [NOTE: See Section 3.E.5 in the Legal Primer for more information on this topic.] When a co-op is formed on a membership basis, the membership shares or units that people purchase to become voting members of the co-op are not securities because, as mentioned earlier, they do not appreciate, pay no dividends and are redeemable at face value only at the discretion of the Board. However, the other financing that a new co-op may require from its members is likely to fall under a securities designation. These include various classes of preferred shares and member loans. These constitute securities defined as debt or equity interest that 1) pay a return for the use of money and/or 2) will appreciate in value.

Both federal and state governments regulate the sale of securities with close scrutiny. Co-ops are like any other business organization in the sense that all must comply with regulations regarding

the sale of securities. Regulation comes in two forms, the first of which is registration and the second is disclosure.

Registration is the process for approval of securities with the security division of the federal Securities and Exchange Commission (SEC) and the applicable state agency. Registration must be evaluated both at federal and state levels, and it may be avoided by selection of an appropriate exemption from registration. Registration is a lengthy and expensive process, and should be avoided if an appropriate exemption is available. However, state and federal laws prohibit the use of "scheme or artifice" (i.e. willful misrepresentation) to avoid registration, so we emphasize that the exemption must be appropriate for the co-op's situation. Legal guidance is recommended for any decisions about qualification for an exemption from registration.

At the federal level, the registration occurs with the SEC and is likely to occur if securities (for example, members loans and preferred shares) are being provided by co-op members that live in states other than the state the co-op is incorporated in (another exemption might work in this case; see the primer for a wider discussion of exemptions). If securities are being issued only to members that live in the co-op's state of incorporation, the co-op can issue the securities under a self-executing intrastate exemption from the SEC, meaning it does not have to register its securities with the SEC.

At the state level, securities laws vary by state. Check with your state to determine if there is an appropriate exemption from registration for co-ops. Some states provide a co-op exemption with only the filing of an issuer registration form. Other exemptions are self-executing and require no action whatsoever by the co-op. In states without an automatic exemption, co-ops will have to fill out forms specified by the state. Occasionally, negotiations with the state may be necessary to obtain exemption. Again, registration can be very costly and time-consuming so it is preferable that a new co-op finds an appropriate exemption from registration for its securities.

Disclosure of all material risks is always required for any offering of securities. Disclosure is done whether or not federal and/or state exemptions from registration have been received. The disclosure document (usually described as a "confidential information statement", or "private placement memorandum" or "prospectus") details any material risks that could affect the member's decision to loan money to the co-op. A few examples of material risk are a significant bank loan that the co-op has taken on, or significant deficiencies in the building a co-op owns. The disclosure document is a legal document, and legal expertise should be obtained in the writing of the document. The co-op and its Board are liable for any deficiencies in disclosure whereby material risks are not included or misrepresented in the disclosure document. Deficiencies in disclosure may be either failure to include information about material risks (omission) or innocent misrepresentations of material risks (commission).

**Does the length of time a co-op has been incorporated affect this?** This is where another form of exemption from registration may come into play. The longer the group has been together as a co-op, the stronger the legal argument for an exemption in doing a private offering for purposes of obtaining member loans/equity. If a co-op can make a private offering of stock only to its members without advertising, and not a public offering, it can obtain an exemption from registration under federal and state laws. And this is another reason for incorporating as early as possible. Please review the primer for a wider discussion of the private offering exemption.

**Can the co-op solicit membership and an offering of stock/loan at the same time?**

No, the person must become a member before they are approached with an offering.

**B. How can bylaws be structured for flexibility and mutual benefit in raising, rewarding, and returning member capital?** (See <http://cdfsfood.coop/bestpractices> for the CDS/CoCoMAMA compendium of best practices for co-op membership and marketing.) The bylaws should allow for the creation of multiple classes and series of units or shares of equity interests, including common and preferred units/shares. Within a share class, we recommend only one member type. For example, we suggest that there be one type of common share at one amount for each member. The bylaws should also not create any obligation on the Board to redeem common shares (or membership units/interests) on any basis other than the exercise of the discretion of the Board of Directors. Allowing for automatic redemption would require continuous tracking of the location of members, and would result in much bookkeeping and costly payouts.

**How can/should multiple types of shares/stock be used to raise member investment capital? Why not just one class of shares, equity/voting, and then raise member loans?** Keeping it simple is always a good business axiom, but maximum flexibility should be maintained. For example, a co-op may want to offer more than one series of equity interests with varying levels of dividend paid if some members will accept a lower return while others will demand a higher return. At the same time, the co-op will want to have the flexibility to raise capital from member loans (i.e. debt capital) in addition to equity capital from the sale of equity interests.

**C. If a co-op has incorporated in a state other than where it is located, and then wishes to raise member loans, will it be at a disadvantage?** [NOTE: See 2.D in Legal Primer for more detail] The co-op could be disadvantaged if it desires to use the intrastate exemption from federal registration. To rely on the intrastate exemption from federal registration, the securities must all be sold within the boundaries of one state to residents of that state by an organization incorporated within that state.

**D. How important is Director and Officer (D&O) Insurance and when should it be obtained?** [NOTE: See 3.D in Legal Primer for more detail.] D&O insurance is very important. Insurance should be purchased as soon as it can be afforded. Until then, the directors must rely on the protection of the corporate shield and the business judgment rule. The business judgment rule holds that the decisions of directors will not be overturned by courts of law if the decision is properly informed, the decision is made by directors without conflict of interests, and the decision is made with the best interests of the business organization in mind. D&O insurance is usually very cost effective when one considers the cost of legal representation alone, which the insurance company will usually be required to pay under the insurance contract. A D&O policy will typically exclude liability from issuance of securities (member loans, etc), but payment of legal costs of representation of the board will usually be covered and is nonetheless important. Always have the D&O insurance contract reviewed to determine (1) the scope of coverage is what you intended, and (2) under what circumstances a defense will be provided. Concerning securities, or any other area of potential liability, if all legal duties are carried out appropriately by directors, the risk of liability is minimized. Performing their legal duties well should be the first area of attention for directors. In case of legal action, adequate performance of these duties will allow the director to mount a good defense. D&O insurance provides a safety net in case of legal action for some or all of the expenses.

**E. What degree of liability do board members hold for loans to the co-op, either as a board or as individuals?** [NOTE: See 3.C in Legal Primer for more detail.] Each director has individual exposure, and the advice of an attorney is important to managing risk. D&O insurance will typically not cover losses that any purchaser of securities may incur by reason of not recovering their investment. Moreover, statutes allow plaintiffs to pierce the corporate shield to recover from individual directors, who are jointly and severally liable. The legalese of "jointly or severally liable" means that one or more directors who have assets may be liable for the full amount of a lawsuit when other directors do not have assets. The Board must insist that if a security is offered by the co-op, that (1) an appropriate exemption from registration is found or the security is registered, and (2) adequate disclosure of all material risks be made known in an offering or disclosure document.

## **Appendix 2: Articles of Incorporation Template**

### **ARTICLES OF INCORPORATION OF**

**[Co-op's Name]**

**A Cooperative Organized Under  
[State of Incorporation] Statutes, Chapter \_\_\_\_\_**

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#### **ARTICLE I. NAME**

The name of this association shall be \_\_\_\_\_

#### **ARTICLE II. PURPOSE**

The Corporation is member owned and shall be operated on a cooperative basis. The purposes for which the corporation is organized are to operate a food cooperative business so that members can buy their groceries and other personal and household items; and for any other purpose which is lawful under the corporation statutes of [state of incorporation].

#### **ARTICLE III. PRINCIPAL PLACE OF BUSINESS AND ADDRESS**

The principal place of business and registered office of this association shall be at \_\_\_\_\_.

**ARTICLE IV.  
PERIOD OF DURATION**

The period of duration of this association shall be perpetual.

**ARTICLE V.  
MEMBERSHIP**

**Section 5.01. Membership Basis.** This association is organized without common stock on a membership basis.

**Section 5.02. Transfer.** A membership is transferable only with the consent and approval of the board.

**ARTICLE V.  
Capital Stock**

**[NOTE: This section is presented as an optional Article V for  
those co-ops wishing to form on a stock basis.]**

**Section 5.01 Stock Basis.** The aggregate number of shares the corporation has authority to issue shall be \_\_\_\_\_ (\_\_\_\_,000) shares of capital stock, which shall have a par value of \$\_\_\_\_ per share, and which shall consist of \_\_\_\_\_ (\_\_\_\_,000) shares of common stock and \_\_\_\_\_ (\_\_\_\_,000) undesignated shares. The Board of Directors, without member or stockholder approval, is granted the express authority, by resolution, to establish from the undesignated shares one or more classes or series of shares, to designate each class or series, and to fix and establish the designations, powers, preferences, and governance and veto rights, including member or stockholder voting rights and rights to appoint or elect directors to the Board, qualifications, limitations or restrictions of each additional class of stock (and the corresponding obligation to fix and establish these designations, powers, preferences, governance and other rights, qualifications, limitations and restrictions whenever any additional class is established). The power of the Board extends to and includes the express authority to create classes and series, without member or stockholder approval, which have terms granting the additional class and/or series (and the holders of thereof) rights, powers, preferences and privileges greater than the rights, powers, preferences and privileges associated with any previously established and designated class or series, including but not limited to, creating patron and non-patron class and series designations. The rights, powers, preferences and privileges are the same for all series within a class except as expressly provided otherwise in the class designation approved by the Board, or the subscription or other agreement regarding the series approved by the Board. In no case may the patrons' interest in governance rights be reduced below 80% of the governance rights of all patron and non-patron members.

**Section 5.02 Voting Rights.** Except as otherwise required by law or pursuant to Section 5.1 hereof, the holders of the shares of common stock shall have the sole voting rights of the corporation.

**Section 5.03 Voting Power.** The members shall take action by the affirmative vote of the holders of a majority of the voting power of the shares represented and voting at a duly held

meeting, except where the affirmative vote of a majority of the voting power of all voting shares is required by statute, and except where the holders of a class or series are entitled by statute to vote as a class or series whether or not such holders are otherwise entitled to vote.

**Section 5.04 Stock Ownership.** The members of this corporation shall have no preemptive rights to subscribe for or otherwise acquire any new or additional shares of stock of this corporation of any class whether now authorized or authorized hereafter, or any options or warrants to purchase, subscribe for or otherwise acquire any such new or additional shares of any class, or any shares, bonds, notes, debentures, or other securities convertible into or carrying options or warrants to purchase, subscribe for, or otherwise acquire any such new or additional shares of any class.

**ARTICLE VI.  
PATRONS' NET MARGINS**

Net income in excess of dividends and additions to reserve shall be distributed on the basis of patronage.

**ARTICLE VII.  
VOTING**

Each member shall have one vote in the affairs of the cooperative.

**ARTICLE VIII.  
DIVIDENDS**

Dividends on any interest in the association may not exceed eight percent annually.

**ARTICLE IX.  
DIRECTORS**

The Cooperative shall be governed by a Board of Directors not less than five (5) directors in size:

Name	Address	First Term Ends

**ARTICLE X.  
LIABILITY**

No director or officer of this cooperative shall be personally liable to the cooperative or its members for monetary damages for breach of fiduciary duty as a director, except for liability:

- (a) for a breach of the director's duty of loyalty to this cooperative or its members;
- (b) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law;
- (c) for a transaction from which the director derived an improper personal benefit; or
- (d) for an act or omission occurring prior to the date when the provisions of this Article X became effective.

It is the intention of the members of this cooperative to eliminate or limit the personal liability of the directors and officers of this association to the greatest extent permitted by [State of Incorporation] law. If amendments to the [State of Incorporation] Statutes are passed after this Article X becomes effective which authorize cooperative associations to act to further eliminate or limit the personal liability of directors, then the liability of the directors and officers of this cooperative shall be eliminated or limited to the greatest extent permitted by the [State of Incorporation] Statutes, as so amended. Any repeal or modification of this Article X by the members of this cooperative shall not adversely affect any right of or any protection available to a director or officer of this association which is in existence at the time of or such repeal modification.

**ARTICLE XI.  
INCORPORATOR(S) (MINIMUM OF ONE PERSON, NO MAXIMUM)**

Date	Name	Signature
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# Appendix 3: Bylaw Template

## BYLAWS OF

[Co-op's Name]

A Cooperative Organized Under  
[State of Incorporation] Statutes, Chapter \_\_\_\_\_

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### BYLAW I: MEMBERSHIP

**Section 1.01. Eligibility for Membership.** Persons may, upon the approval of the Board of Directors of this cooperative, become a member of this cooperative by:

(a) becoming the holder of one Class A Unit (“Membership Unit”) of this cooperative; and [NOTE: A term other than Unit can be chosen. However if your co-op is not a stock co-op, then the terms share or stock should not be used.]

(b) receiving from this cooperative written acceptance of membership;

(c) meeting other membership criteria or requirements established from time to time by the Board of Directors; and

(d) the Board of Directors may establish one or more classes of non-voting memberships on terms and conditions established by the Board of Directors.

**Section 1.02. Termination of Membership.** Membership in this cooperative may be terminated by the Board of Directors at their discretion if the Board of Directors determines that a member has:

(a) become ineligible for membership for any reason;

(b) died or ceased to exist as a legal entity and leaves no successor; or

(c) the Board of Directors by resolution finds that a member has:

(1) intentionally or repeatedly violated any provision of the Articles, the Bylaws, or Board policies of this cooperative;

(2) taken actions that will impede this cooperative from accomplishing its purposes;

- (3) taken or threatened actions that adversely affect the interests of this cooperative or its members;
- (4) willfully obstructed any lawful purpose or activity of this cooperative; or
- (5) breached any contract with this cooperative.

The Board of Directors may terminate the membership of a member only at a meeting of the Board of Directors, having given 20 days prior written notice of which was served upon the last known mailing address of the member alleged to be ineligible by United States Certified Mail. The notice must state with reasonable particularity the grounds upon which the member is alleged to be ineligible and that the member will be entitled to be heard on the matter of termination at the meeting.

### **Section 1.03. Consequences of Membership Termination.**

(a) If the Board of Directors finds that any Membership Units of this cooperative have come into the hands of any person who is not eligible to own Membership Units or who has otherwise become ineligible for membership in this cooperative, the Board of Directors of this cooperative has the right, at its option, (i) to redeem the Membership Units at an amount equal to the value of the consideration for which the Membership Units were issued; or (ii) to convert the Membership Units into a nonvoting certificate of interest or other nonvoting equity credit at an amount equal to the value of the consideration for which the Membership Units were issued. Upon such redemption or conversion, such ineligible holder of Membership Units will cease to be a member of this cooperative and will cease to have voting rights in this cooperative.

(b) In exercising its right to redeem or to convert the Membership Units under the preceding paragraph, this cooperative may cancel the certificate or certificates of such Membership Units on its books if the holder fails to deliver the certificate or certificates evidencing such Membership Units to the cooperative. If this cooperative exercises its right to convert the Membership Units into a nonvoting certificate of interest or other nonvoting equity credit, this cooperative will have no obligation to redeem such nonvoting equity interest, nor shall the holder of such interest have any right to demand the redemption thereof.

(c) Other than as provided in Section 1.03(a), the termination of membership or other action taken by this cooperative with respect to a member or the member's Membership Units will not modify the obligations and liabilities of any holder thereof to this cooperative under any supply contract, service contract, or other contract between the holder and this cooperative, nor impair the rights of this cooperative under such contracts.

(d) A non-voting membership interest may be terminated without prior notice, and the Board shall have the same options for the financial interest, if any, associated with the non-voting membership.

(e) When the Articles of Incorporation and/or Bylaws refer to a “member” or “membership”, the reference is exclusively to “voting” members.

## **BYLAW II: MEETINGS OF MEMBERS**

**Section 2.01. Annual Meetings.** The annual meeting of the members of this cooperative shall be held following the close of each fiscal year of this cooperative at such time and place as shall be determined by the Board of Directors. The notice of the meeting shall state the date, place and hour of the meeting. The Secretary shall give notice of annual members’ meetings in the manner prescribed herein. The officers of this cooperative must submit reports to the members at the annual meeting covering the business of this cooperative for the previous fiscal year that show the condition of this cooperative at the close of the fiscal year. At the annual meeting, the members shall elect directors of this cooperative for the terms of office and in the manner prescribed by the Bylaws and transact such other business as may properly come before the meeting.

**Section 2.02. Special Member Meetings.** Special meetings of the members of this cooperative shall be held at the place specified in the notice of the meeting. The notice shall state the time, place and purpose of the special members’ meeting. A special meeting of the members may be called by a majority vote of the Board of Directors, or upon the written petition of at least 20% of the members submitted to the Chair of this cooperative. The Chair shall give notice of a special members’ meeting in the manner prescribed herein. In the event a special members’ meeting is called by the written petition of members, the notice of the special members’ meeting shall be given within thirty (30) days from and after the date of the presentation of the members’ petition, and the special members’ meeting must be held by sixty (60) days after the date of the presentation of the members’ petition. No business shall be considered at a special members’ meeting except as covered in the notice of the meeting.

**Section 2.03. Notice.** Notice of all annual and special members’ meetings shall be given by at least one of:

(a) publication in a legal newspaper published in the county of the principal place of business of this cooperative;

(b) publication in a magazine, periodical, or other publication of this cooperative that is regularly published by or on behalf of this cooperative and circulated generally among members;

(c) mailing the notice of the meeting to each member personally at the member's last known post office address, or

(d) otherwise providing notice in a manner prescribed by applicable law.

Failure of a member to receive notice of an annual or special members' meeting shall not invalidate an action that is taken by the members at a members' meeting. The Secretary shall execute a certificate containing a correct copy of the mailed or published notice; the date of mailing or publishing the notice; and a statement that the notices were mailed or published as prescribed by [check statutory citation]. The certificate shall be made a part of the record of the meeting.

**Section 2.04. Quorum.** At any annual or special members' meeting, a quorum necessary for the transaction of business shall be ten percent (10%) of the total number of members if the cooperative has 500 or fewer members; or the lesser of five percent (5%) or two hundred (200) if the cooperative has more than 500 members. In determining a quorum at a meeting, on a question submitted to a vote by mail, members present in person or represented by mail vote shall be counted. The attendance of a sufficient number of members to constitute a quorum shall be established by a registration of the members present in person or by mail ballot at the meeting.

**Section 2.05. Voting.** Each member shall be entitled to only one vote. A member's vote at a members' meeting must be in person or may be by absentee ballot if absentee vote is authorized by the Board of Directors. Voting by proxy and cumulative voting is not permitted. Members that are not individual persons must designate a representative (and may also designate an alternate representative) authorized to cast their vote in the affairs of this cooperative. The designation must be in writing, must be properly authorized by the member, and must be provided to the Secretary of this cooperative at or before the member meeting. The written designation will remain effective until it is superseded by a more recent written designation meeting the same criteria. Except where a higher percentage is specified in the Bylaws or required by applicable law, members shall take action on all matters submitted to them by the affirmative vote of a majority of the votes cast at a duly held meeting, either in person or by absentee vote if an absentee ballot has been authorized by the Board of Directors.

**Section 2.06. Absentee Vote.** A member who is absent from a members' meeting may vote on the ballot prescribed hereunder on any motion, resolution, or amendment that the Board of Directors submits for vote to the members. The vote must be cast on a ballot that is in the form prescribed by the Board of Directors, that contains the exact text of the proposed motion, resolution or amendment to be acted upon at the meeting, that contains spaces in which the member may indicate an affirmative or negative vote thereon, and that otherwise meets the requirements of [State of Incorporation] law. The ballot, when completed by an absent member and received by this cooperative in the manner prescribed by the Board of Directors, shall be counted as the vote of the member at the meeting.

## BYLAW III: DIRECTORS

**Section 3.01. Number, Qualifications and Terms of Office.** The business and affairs of this cooperative will be governed by the Board of Directors, with the Board of Directors upon the adoption of these Bylaws consisting of \_\_\_\_\_ (\_\_\_) directors. [NOTE: We recommend seven or nine directors.] Each director must be a member of this cooperative, provided, however, that the Board of Directors may, in its discretion, specify that up to one (1) director at any time may be a non-member. Except as otherwise provided herein, all directors shall serve three-year terms and until their successors are duly elected and qualified. In order to preserve continuity of governance and the harmonious transition of the initial Board of Directors to the elected Board of Directors, the terms of the directors of the initial Board of Directors shall be staggered such that one-third of the directors (or as nearly as possible) shall be elected at the annual members' meeting following the date on which the Board of Directors determines that the initial membership in this cooperative has been established and at each annual meeting thereafter. The Board of Directors shall adopt a procedure to achieve the desired staggered effect prescribed by the Bylaws. Co-op employees and their spouses or significant others are not eligible to serve as directors.

**Section 3.02. General Powers.** The Board of Directors shall govern the business and affairs of this cooperative and shall exercise all of the powers of this cooperative, except those powers that are conferred upon or reserved to the members by law, the Articles of Incorporation, or these Bylaws. The Board of Directors shall adopt such policies, rules, and regulations and shall take such actions as it may deem advisable, provided that the Board of Directors does not act in a manner inconsistent with law, the Articles of Incorporation, or these Bylaws.

**Section 3.03. Committees.** By resolution, the Board of Directors may designate three or more directors, one of whom shall be the Chair of this cooperative, to constitute an Executive Committee. The Executive Committee shall have and exercise only such authority of the Board of Directors in the management of this cooperative to the extent provided in the resolution. The Board of Directors may establish such other committees from time to time as it deems advisable, having such authority as provided by the Board of Directors. Committees are subject at all times to the direction and control of the Board of Directors.

**Section 3.04. Director Eligibility.** During his or her term of employment an employee of this cooperative shall not be eligible to serve as a voting member of the Board of Directors of this cooperative, nor shall her/his spouse or significant other. However, the Manager of this cooperative is permitted but not required to serve in a non-voting advisory role to the Board of Directors. For purposes of clarification, this section is neither intended to burden the Manager with the additional fiduciary obligations borne by directors nor benefit the Manager with such rights afforded to Directors as voting, notice and counting towards quorum.

**Section 3.05. Financial Matters.** The Board of Directors shall have the power to select one or more banks or other financial institutions to act as depositories of the funds of this cooperative, and to determine the person or persons who shall have authority to sign checks and other instruments.

**Section 3.06. Election of Directors.** Directors shall be elected by ballot at the annual meetings. Nominations for director may be made by the board or by petition signed by at least twenty-five (25) members entitled to vote and submitted to the Secretary at least thirty (30) days before the annual meeting.

Members may vote by mail and/or electronic ballot for the election of directors, provided a mail ballot is specifically authorized by the Board of Directors.

The nominees receiving the highest number of votes cast shall be elected and shall take office at the adjournment of the Annual Meeting. [NOTE: If there are multiple nominations for a seat, this statement allows for the nominee with the highest votes, but who does not have a simple majority, to win the seat without a run-off election.]

**Section 3.07. Annual Meeting.** Within 30 days after each annual members' meeting, the Board of Directors shall meet for the purpose of electing officers of this cooperative and for the transaction of such other business as shall come before the meeting. The annual meeting of the Board of Directors shall be held at such time and place as may be fixed by the Board of Directors.

**Section 3.08. Regular Meeting.** Regular meetings of the Board of Directors shall be held from time to time at such time and place as may be fixed by the Board of Directors.

**Section 3.09. Special Meetings.** Special meetings of the Board of Directors may be called by the Chair, and must be called upon request by any three of the directors. Special meetings of the board shall be held from time to time at a time and place as may be designated in the notice of the meeting.

**Section 3.10. Notice of Meetings.** Notice of each annual, regular or special meeting of the Board of Directors shall be given by the Chair or Secretary who shall give at least five days prior notice of the meeting to each director by mail, telephone, telephonic facsimile transmission, telegram, electronic mail or in person unless, a shorter time period is otherwise agreed to. Notice shall be deemed given upon mailing, if notice is given by mail.

**Section 3.11. Waiver of Notice.** Notice of any meeting of the Board of Directors may be waived either before, at, or after the meeting, in writing signed by each director. A director, by attendance at any meeting of the Board of Directors, shall be deemed to have waived notice of such meeting, except when a director attends the meeting and objects to the transaction of business because the meeting was not lawfully convened.

**Section 3.12. Quorum; Board Action.** A majority of the members of Board of Directors shall constitute a quorum for the transaction of business except that, when a vacancy or vacancies exist, a majority of the remaining directors shall constitute a quorum. The Board of Directors shall take action by the affirmative vote of a majority of the directors present at a duly held meeting.

**Section 3.13. Action Without a Meeting.** Any action required or permitted to be taken at a meeting of the Board of Directors may be taken by written action signed by all of the directors. The written action is effective when signed by all of the directors, unless a different effective time is provided in the written action.

**Section 3.14. Electronic Communications.** Any meeting of the Board of Directors may be conducted by telephone or other electronic means of communication through which the directors may simultaneously communicate with one another.

**Section 3.15. Vacancies.** If a director's position is vacant, the Board of Directors may appoint a member of this cooperative to fill the directors' position until the next annual or special members' meeting. At the next annual or special members' meeting, the members shall elect a director to fill the unexpired term of the vacant director's position.

**Section 3.16. Removal.** Any individual director may be removed from office for cause by a vote of a majority of the members entitled to vote at any annual or special meeting at which said removal of directors is considered. For purposes of this Section, "for cause" shall include failure of a director to attend three consecutive or four meetings of the Board of Directors held in the prior fiscal year, misfeasance or malfeasance. In case any director is so removed at an annual or special meeting, a successor director shall be elected at the same meeting. Any director may also be removed from office by the Board of Directors for cause if a two-thirds majority of the other directors affirmatively vote in favor of removal.

**Section 3.17. Removal of Directors by Board.** Each director shall fully comply with the Board of Director's policy manual established by the Board of Directors. The Board of Directors, not including a director thought to be in violation of the manual, may remove a director who is disqualified by the policies in that manual. The remaining directors may also fill any vacancy caused by such removal until the next annual meeting of the members. This removal power shall be in addition to the power of the members under Section 3.12 above, but the process for removal under this Section 3.13 shall be governed exclusively by the policy manual.

**Section 3.18. Compensation.** Directors shall receive such fixed sum per meeting attended or such fixed annual sum as shall be determined, from time to time, by resolution of the Board of Directors. All directors shall be reimbursed for their expenses, if any, of attendance at meetings of the Board of Directors or any committee thereof. Nothing in these Bylaws shall be construed to preclude any director from serving this cooperative in any other capacity and receiving proper compensation for the service.

## **BYLAW IV: OFFICERS**

**Section 4.01. Officers.** The officers of this cooperative shall be a Chair, a Vice-Chair, a Secretary and a Treasurer, who shall be elected in the manner as provided in Section 5.07 of these Bylaws. The offices of the Secretary and Treasurer may be combined and when so combined shall be termed "Secretary-Treasurer." Except for the Secretary-Treasurer, no offices may be held concurrently by the same person. The Chair and Vice-Chair must be directors and members of this cooperative. The Board of Directors may elect other officers from time to time as it deems advisable or as required by these Bylaws, and in such event shall establish appropriate duties and responsibilities for any such other officers.

**Section 4.02. Chair.** The Chair shall see that all orders and resolutions of the Board of Directors are carried into effect and shall preside at all meetings of the members and directors. The Chair shall be the official representative of this cooperative to all outside associations or organizations of which this cooperative is a member, unless another person is appointed by the Chair or other action is taken by the Board of Directors. The Chair shall sign and deliver in the name of this cooperative any deeds, mortgages, bonds, contracts and other instruments pertaining to the business of this cooperative, except in cases in which the authority to sign and deliver is required by law to be exercised by another person or is expressly delegated by the Articles or the Bylaws or the Board to some other officer or agent of this cooperative. This broad signing authority shall not be construed so as to preclude the Board of Directors from authorizing any other officer or agent of this cooperative to sign any deeds, mortgages, bonds, contracts and other instruments pertaining to the business of this cooperative on behalf of this cooperative. The Chair shall have such other duties as may, from time to time, be assigned by the Board of Directors.

**Section 4.03. Vice-Chair.** The Vice-Chair shall have powers and perform duties as may be specified in the Bylaws or prescribed by the Board of Directors or by the Chair. In the event of the absence or disability of the Chair, the Vice-Chair shall perform the duties and exercise the powers of the Chair.

**Section 4.04. Secretary.** Subject to the discretion of the Board of Directors, the Secretary shall attend all meetings of the members and Board of Directors; record all votes at and keep minutes of all the meetings; and record all proceedings of the meetings in the minute book of this cooperative. The Secretary shall give proper notice of meetings of the members and of the Board of Directors. The Secretary shall perform such other duties as may, from time to time, be prescribed by the Board of Directors or by the Chair.

**Section 4.05. Treasurer.** Subject to the discretion of the Board of Directors, the Treasurer shall be the custodian of all funds, securities and properties of this cooperative and shall perform such other duties with respect to the finances of this cooperative as

may be prescribed by the Board of Directors or by the Chair. This function may be delegated by the board to management with oversight by the treasurer or the board.

**Section 4.06. Compensation of Officers.** The officers of this cooperative shall receive compensation for their services as may be determined, from time to time, by resolution of the Board of Directors. No officer who is a director may take part in the vote on his or her salary for services rendered to the cooperative.

**Section 4.07. Election of Officers.** On an annual basis, the Board of Directors shall elect from its members a Chair and one or more Vice-Chairs. Election for persons to fill any other offices established by these Bylaws or by the Board of Directors pursuant to Section 5.01 of these Bylaws shall be held at the annual meeting of the Board of Directors or at any other meeting of the Board of Directors, provided that notice of such election has been given in the notice of such meeting if other than the annual meeting. The officers shall hold their offices until their successors have been elected and have qualified, subject to any removal provisions of these Bylaws.

**Section 4.08. Removal of Officers.** The members may remove an officer at a members' meeting for cause related to the duties of the position of the officer and fill the vacancy caused by the removal. In addition, any officer may be removed by the Board of Directors whenever in its judgment the best interests of the cooperative will be served. Any vacancy among the officers caused by such removal shall be filled by the Board of Directors. No election or appointment to an office of this cooperative shall itself create any contract rights.

## **BYLAW V: INDEMNIFICATION AND INSURANCE**

**Section 5.01. Indemnification.** This cooperative shall indemnify each person who is or was a director, officer, manager, employee or agent of this cooperative, and any person serving at the request of this cooperative as a director, officer, manager, employee or agent of another corporation, partnership, joint venture, trust, or other enterprise, against expenses, including attorneys' fees, judgments, fines, and amounts paid in settlement actually and reasonably incurred to the extent to which such directors, officers, managers, employees or agents of this cooperative may be indemnified under the law of [State of Incorporation].

**Section 5.02. Insurance.** This cooperative shall have the power to purchase and maintain insurance on behalf of any person who is or was a director, officer, manager, employee, or agent of this cooperative against liability asserted against and incurred by the person in the person's capacity as a director, officer, manager, employee or agent, or arising from the person's status as a director, officer, manager, employee, or agent of the cooperative.

## BYLAW VI: FINANCE

**Section 6.01. Financial Operation.** This corporation operates on a cooperative basis and allocates earnings and losses to patron-members on the basis of the business done with or for such patrons. Thus, in accordance with section 1381 of the Internal Revenue Code of 1954, this corporation shall declare a patronage dividend to be distributed among the members in accordance with the total amount of purchases made by each such patron during the preceding fiscal year.

**Section 6.02. Patronage Dividend.** The patronage dividend, as determined by the Board of Directors, shall be non-cash payments in the form of “qualified written notes of allocation” as defined in section 1388 of the Internal Revenue Code of 1954. In accordance with Section 1382 of the Internal Revenue Code, the patronage dividends declared by the corporation are deductible from the taxable income of the corporation and must be included in the taxable personal income of the member to the extent provided by law.

Each member shall have an internal capital account in his or her name. The surplus earnings of the company after paying taxes, interest on loans, and allocations to the Reserve Fund (See Section 10 below) shall be allocated to members as a patronage dividend. Unless otherwise decided by the Board of Directors, the patronage dividend shall be credited to the owners’ Internal Accounts. At least 20% of each year's patronage allocation must be paid out in cash/check to members.

**Section 6.03. Equity Capital.** The Board of Directors shall manage the Cooperative’s equity capital in a way to preserve and build upon the Cooperative’s financial position while also allowing for redemptions of equity as and when the Cooperative has the financial strength to redeem equity. The Board of Directors may, from time to time, establish policies for redeeming equities, stock, or other forms of equity used for qualified or non-qualified notices of allocation, or the Board may eliminate equity redemption policies in favor of a capital management policy. Any of these policies may contain offers of discounts or required retentions of capital as part of any redemption of allocated equity. The Board retains the power to amend, modify or repeal these policies and may do so retroactively, all in the Board’s sole discretion. For example, if the application of a policy to a specific circumstance suggests that the equity of a deceased member should be paid to the member’s estate, the Board of Directors retains the right and power to determine whether to approve the expenditure. In each case, the Board of Directors may refuse any expenditure(s) if the Board determines that such expenditure(s) is (are) not in the interest of the cooperative. Therefore, no equity redemption policy shall be interpreted to require any expenditure of capital and the Board of Directors retains all right and power to the final review and approval of each expenditure of capital for any redemption of equity. No person shall have any right whatsoever to require the retirement or redemption of any patrons’ equities except in accordance with their term, or of any allocated capital reserve. Any redemption or retirement is solely within the discretion and on such terms as determined from time to time by the Board of Directors of this Cooperative, which may, in making any such redemption or retirement, distinguish natural members from unnatural members

(corporations, partnerships, LLCs and other business organizations, etc.) and, in doing so, favor natural members with respect to estate retirements and redemptions at specified ages.

## **BYLAW VII: CONSENT**

**Section 7.01. Consent to Take Patronage Distributions Into Income.** Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative as of the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to its patronage which are made in written notices of allocation (as defined in 26 U.S.C. § 1388), and which are received by the member from this cooperative, will be taken into account by the member at their stated dollar amounts in the manner provided in 26 U.S.C. § 1385(a) in the taxable year in which the written notices of allocation are received by the member.

## **BYLAW VIII: MERGER OR CONSOLIDATION; DISSOLUTION**

**Section 8.01. Merger or Consolidation.** If the terms of a merger or consolidation of which this cooperative is a party do not provide the members of this cooperative with an economic interest in the surviving entity that is substantially similar to the economic interest possessed by such members in this cooperative immediately before such merger or consolidation, the value of the consideration received shall be divided among them in the same manner as a comparable amount of net liquidation proceeds would be distributed pursuant to Section 9.02. This shall not be construed to prevent issuance of differing forms of consideration to different groups of members to the extent allowed by law.

**Section 8.02. Liquidation, Dissolution and Winding-Up.** Subject to the Articles of Incorporation, in the event of any liquidation, dissolution or winding up of the affairs of this cooperative, whether voluntary or involuntary, all debts and liabilities of this cooperative shall be paid first according to their respective priorities. The remaining assets shall be distributed in the following manner and order of preference: (1) outstanding membership loans; (2) second to the holders of Membership Units in an amount equal to the value of the consideration for which the Membership Units were issued, without priority and on a pro rata basis if necessary; (3) third to payment of the stated dollar amount of all Patrons' Equities (other than Non-Patronage Earnings Certificates), in chronological order of year beginning with the oldest outstanding Patrons' Equities first and on a pro rata basis within a year if necessary; (4) fourth to payment of the stated dollar amount of Non-Patronage Earnings Certificates, in chronological order of year beginning with the oldest outstanding Non-Patronage Earnings Certificates first and on a pro rata basis within a year if necessary; and (5) fifth to the patrons in accordance with their interest in Capital Reserves. Any assets remaining

after the foregoing payments have been made shall be allocated among the allocation units in the manner as the Board of Directors, having taken into consideration the origin of the amounts, shall determine to be reasonable and equitable. Amounts so allocated shall be paid to current and former patrons of each such allocation unit in proportion to their patronage of the unit over the period as may be determined to be equitable and practicable by the Board of Directors. The obligation to distribute shall be construed as a preexisting duty to distribute any patronage sourced net gain realized in the winding up process to the maximum extent allowable by law.

## **BYLAW IX: RESTRICTIONS ON SALES AND TRANSFERS**

**Section 9.01. Restrictions on Transfer.** For purposes of this Bylaw, the term “transfer” shall mean, as a noun, any voluntary or involuntary transfer, sale, assignment, or other disposition and, as a verb, to voluntarily or involuntarily transfer, sell, assign or otherwise dispose of. The Membership Units of this cooperative are transferable only with the consent and approval of the Board of Directors and may not be pledged. Any purported transfer other than a transfer in accordance with these Bylaws shall be null and void and of no force or effect whatever.

## **BYLAW X: FISCAL YEAR**

The Board of Directors may by resolution adopt a fiscal year of this cooperative from time to time.

## **BYLAW XI: AMMENDMENTS**

Any bylaw may be adopted, amended or repealed by a simple majority of the members present at any regular or special meeting of the members. [NOTE: Two-thirds majority may also be chosen for bylaw changes to protect against special interest groups.]

The Board of Directors may make and amend any bylaws, which amendment is effective immediately. Provided, that any bylaw adopted or amended by said board shall be reported at the next regular member meeting; and provided, further, that any bylaw adopted or amended by said board shall be at any time subject to amendment or repeal by the members upon prior notice.

# Appendix 4: 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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**"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."**

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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 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 "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 self dealing 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.

*Kathryn Sedo is a Clinical Professor at the University of Minnesota Law School, where she teaches a course on cooperative law.*

*This article appeared in the April-May 1986 issue of **Cooperative Grocer**.*

## Appendix 5: Sample Patronage Allocation Letter

Co-op Owner  
Owner Street  
Owner Town  
Member State, 12345

### Notice of Patronage Allocation and Transmittal of Refund

Dear Co-op Owner,

Thank you for patronizing the cooperative during the past year. You have made aggregate purchases from the cooperative in the amount of xxx. Based on your patronage and in accordance with the Cooperative's bylaws, the Cooperative has allocated equity credits to you in the amount of \$xx for the period *[fill in start and end dates]*. Of this amount, *[insert amount of allocation, remembering that up to 80% of the allocation may be retained by the cooperative for working capital]* is being distributed with this letter as a patronage refund.

*[In accordance with the cooperative's bylaws OR By signing and accepting the enclosed check], each owner consents that the amount of any distributions with respect to its patronage which are made in this written notice of allocation (as defined in 26 U.S.C. § 1388), and which are received by the member from this cooperative, will be taken into account by the owner at their stated dollar amounts in the manner provided in 26 U.S.C. § 1385(a) in the taxable year in which the written notices of allocation are received by the owner.*

### What is a Patronage Refund?

Patronage refund is the official name for how co-ops send profits back to their members. As owners of the co-op, members also own the profit.

#### *Here's how it works:*

The Co-op provides its members delicious food and other fun things. Every member purchase is recorded in the membership records. When the Co-op is profitable, the board and management review plans and financial obligations. The co-op sets aside any profit needed to pay for those and records it in each member's account as non-voting shares in the Co-op. The money that is not needed to reinvest in the business is returned by check to the members. Your patronage refund is based on the amount of your purchases over the previous year.

If the purchases you made from the co-op were for your personal consumption and not for business related purposes, our advisers say your dividend will not be taxable to you. However, members are responsible for making your own decisions and you should check with your own tax professionals with any questions or concerns.

Sincerely,

Co-op

## Appendix 6: Further Reading

### From the Food Co-op Initiative Web Site

*The Member Equity Toolbox*

<http://www.foodcoopinitiative.coop/sites/default/files/Member%20Equity%20Toolbox.pdf>

*The Member Loan Toolbox*

<http://www.foodcoopinitiative.coop/sites/default/files/Member%20Loan%20Toolbox.doc>

*Legal Issues for New Co-ops*, Webinar Presentation by Joel Dahlgren, September 2008

<http://cdsconsulting.centraldesktop.com/cdsvideo/doc/6654719/w-LegalIssuesForNewCoops>

### Web links to other sites

Best Practices for Membership Development in Food Co-ops, CoCoMAMAs/Let's Soar, <http://www.cdsconsulting.coop/bestpractices>

Capitalization Strategies, Bill Gessner, Cooperative Grocer #129, March - April 2007 <http://www.cooperativegrocer.coop/articles/index.php?id=723>

Cooperatives In Wisconsin: The Power of Cooperative Action, University of Wisconsin Center for Cooperatives, [http://www.uwcc.wisc.edu/info/uwcc\\_pubs/wiCoops07.pdf](http://www.uwcc.wisc.edu/info/uwcc_pubs/wiCoops07.pdf)

Cooperative Identity, Values and Principles, The International Cooperative Alliance, revised 1995, <http://www.ica.coop/coop/principles.html>

Creating a Cooperative Legacy in Your Community, Patricia Cumbie, Solutions V6, #1, January/February 2007 <http://www.cdsfood.coop/node/155>

Equity: Essential Foundation, Educational Tool, Patricia Cumbie, Solutions V3 N 3 Summer 2003, <http://www.cdsfood.coop/node/242>

Limited Cooperative Association Statutes: An Update, Lynn Pittman, University of Wisconsin Center for Cooperatives, Staff Paper No. 7 April 2008 [www.uwcc.wisc.edu/info/uwcc\\_pubs/staff/staff08.pdf](http://www.uwcc.wisc.edu/info/uwcc_pubs/staff/staff08.pdf)

Membership is Ownership: the Cooperative Advantage, Marilyn Scholl, Cooperative Grocer 136, May-June 2008, <http://cooperativegrocer.coop/articles/index.php?id=804>

Planning Patronage Refunds, Bruce Mayer, Co-op Grocer #134 January February 2008  
<http://www.cooperativegrocer.coop/articles/index.php?id=779>

Planning and Marketing Capital: A greater share in your future?, David Thompson,  
Cooperative Grocer # 48, Sept/October 1993  
<http://www.cooperativegrocer.coop/articles/index.php?id=142>

Three Strategic Concepts for the Guidance of Co-operatives, Brett Fairbairn, 2003  
<http://www.usaskstudies.coop/pdf-files/StratConcepts.pdf>

Uniform Limited Cooperative Association Act, National Conference of Commissioners  
on Uniform State Laws, 2007.  
[http://www.law.upenn.edu/bll/archives/ulc/uarca/2007\\_final.htm](http://www.law.upenn.edu/bll/archives/ulc/uarca/2007_final.htm)

We Own It—At Last!, Ann Marx, Cooperative Grocer # 118 May - June 2005  
<http://www.cooperativegrocer.coop/articles/index.php?id=592>

Bylaws: How Strong Is Your Co-op's Foundation?, Karen Zimbelman, Cooperative  
Grocer #15, February-March 1988.  
<http://cooperativegrocer.coop/articles/index.php?id=39>

Making the Minutes "Ours", Karen Zimbelman, Cooperative Grocer #29, July-August  
1990 <http://cooperativegrocer.coop/articles/index.php?id=89>

Patronage Dividends For Food Co-ops: A Primer on Distributing Earnings and Building Member Capital  
<http://www.cdsconsulting.coop/patronagedividend>