

Better Understanding of Governance Helps Strengthen Cooperatives

BY CLYDE A. HAMSTREET, PRINCIPAL, HAMSTREET & ASSOCIATES

In the ever-expanding domain of global commerce, the word “cooperative” may evoke thoughts of small, local organizations of people combining resources for mutual benefit, rather than billion-dollar super-corporations with fingers in multinational pies. Whether it’s the student co-op from university days, the grocery store down the neighborhood street, or even a credit union, housing association, or rural electric provider, chances are that one thinks of a co-op as a nonprofit business restricted in size or scope, or both.

In fact, however, many cooperatives are highly diversified, large-scale corporations with international clout. Land O’Lakes, Inc., for instance, comprising more than 6,000 individual and cooperative members, had net sales of \$7.7 billion in 2004, while serving all 50 U.S. states and 50 countries worldwide.¹ Ace Hardware operates in more than 70 countries through 4,800 retail member-stores, generating annual sales of \$3 billion.² In the United States, some 48,000 cooperatives serve 120 million Americans in all sectors of commerce, with the 100 largest co-ops generating cumulative revenues of \$119 billion.³ Clearly, these are businesses to be reckoned with.

Cooperatives come in all shapes and sizes, but agricultural organizations possess a particularly venerable pedigree. Having sprouted rapidly all over the United States in the early part of the 20th century, cooperatives have long enabled individual growers to acquire power in the marketplace through legal forms of combination. By enabling producers to purchase supplies and services at lower cost and market their goods more profitably, the cooperative business model serves farming communities particularly well. Forty-one of the top 100 revenue producers among co-ops are agricultural.

At the same time, like farming itself, agricultural cooperatives have cycled through difficult financial periods. The 1980s brought sharp declines to the farming community, and many cooperatives shut their doors. Meanwhile, although new legal and organizational initiatives have revitalized the model, many traditional farmer co-ops are struggling. Whereas their aggregate net income reached almost \$2.4 billion in 1995, since 1999 it has hovered around \$1.3 billion (Figure 1). The overall number of agriculture co-ops has fallen by a quarter in about the same period of time, continuing a long trend (Figure 2).

Consolidations help account for some of the declining numbers, but financially induced closures have also occurred. Agway and Farmland Industries, for example, two prominent farmer co-ops, recently failed to reorganize in bankruptcy and were liquidated. Other co-ops, such as Goldkist, seeking access to broader capital markets, have converted to C corporations. Turnaround professionals would do well to heed both the opportunities and the challenges posed by such upheavals in the cooperative sector.

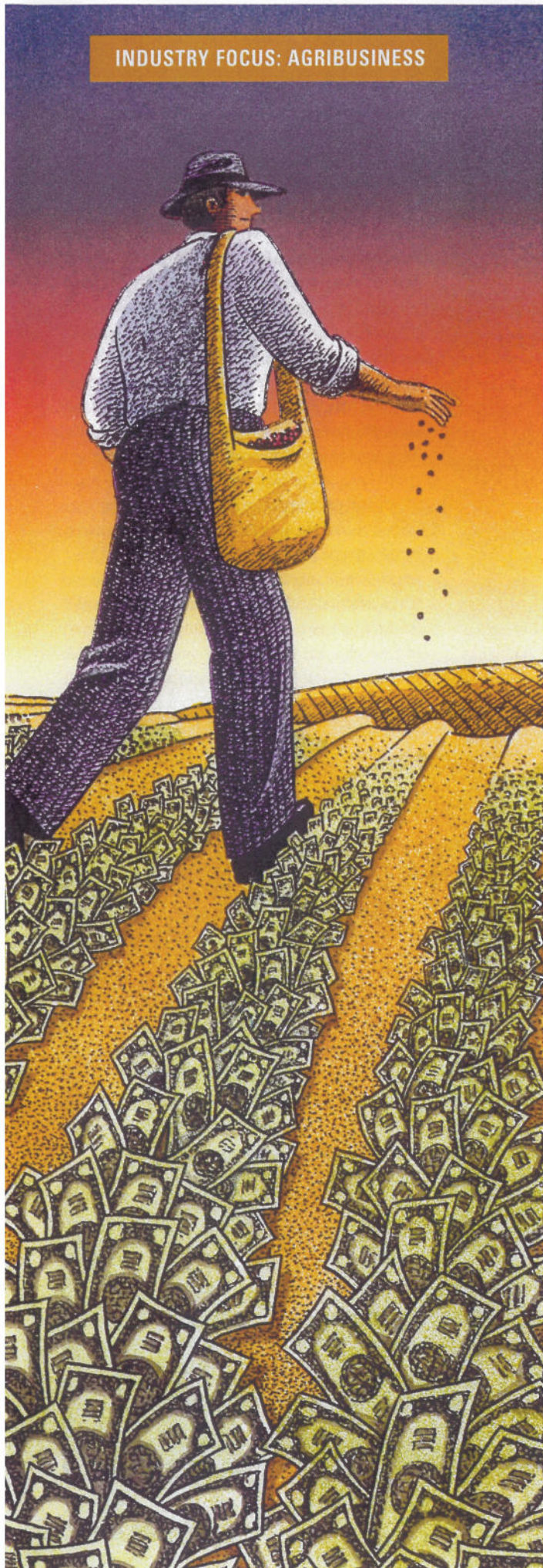
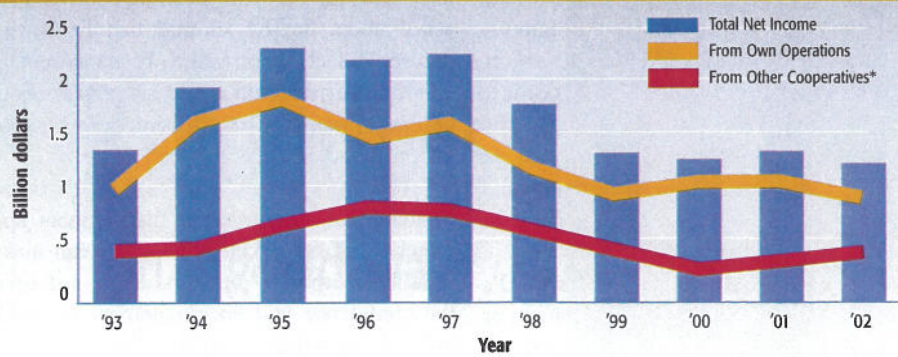
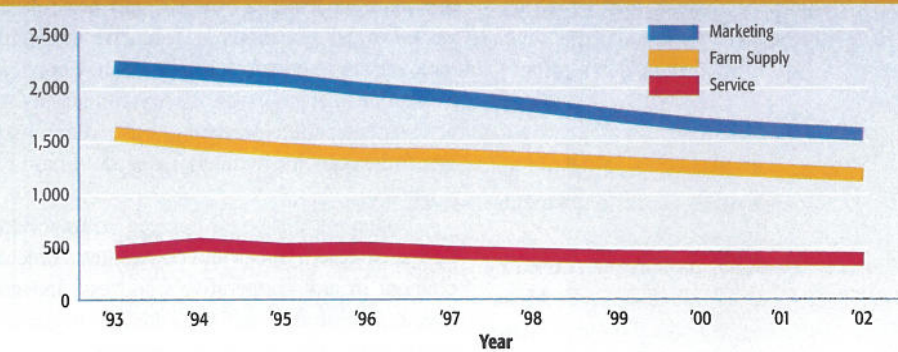


Figure 1: Cooperatives' Net Income, 1993-2002



* Includes dividends and patronage refunds from other farmer cooperatives, CoBank, and Banks for Cooperatives.
Source: USDA Service Report 62 (Farmer Cooperative Statistics, 2002).

Figure 2: Number of Farmer Cooperatives in the United States, 1993-2002



Source: USDA Service Report 62 (Farmer Cooperative Statistics, 2002).

All kinds of companies, including cooperatives, fall into fiscal crisis, usually for the same limited number of reasons. Nevertheless, certain features of cooperative governance foster distinctive patterns of leadership, which over time can generate severe, and sometimes fatal, problems. Successful solutions to the most common ills afflicting cooperatives demand particular attention to their special characteristics. One must understand the basic nature of the organism before attempting to treat its ailments.

Unique Governance Features

Because cooperatives are owned and operated by their members, they often do not draw upon outside talent in composing their boards. Indeed, some states have legislated that all directors be elected from the ranks of co-op members. This means that directors likely know a great deal about the cooperative's underlying industry. A good-sized farm may employ 20 people in a successful operation whose owner knows everything he needs to know about running his business. But that knowledge doesn't necessarily translate well when applied to a multimillion- or billion-dollar entity with 5,000 or 6,000 employees working in an increasingly competitive and technologically driven marketplace. As a result, absent special care to avoid it, an unsophisticated, insular, or weak governance culture can arise.

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Many boards govern their cooperatives very well. Nevertheless, exceptional diligence is needed to offset built-in dangers. Observers point to governance shortcomings as a key factor in cooperative failures. "The greatest threat to the survival of a cooperative is the board of directors." So reads the prominent first line of one tract that addresses meeting the special challenges faced by cooperative boards.⁴

One major source of funding in the agricultural community recently implemented a policy of not lending to co-ops at all, unless a majority of the board possesses financial backgrounds independent of the co-op's business and fortunes. Surveys of former members of the now-defunct Rice Growers Association of California (RGA) cited poor decision making and lack of attention among board members as important features in that entity's demise. Former RGA managers said that the board was "passive and ill-equipped to scrutinize the complex business decisions it was charged with supervising."⁵

In the recent successful turnaround of the \$1.8 billion Southern States Cooperative, the board gave a similarly negative initial impression to its new chief restructuring officer (CRO). During the CRO's first board meeting, which occurred via conference call, the CEO introduced him and went on to provide a detailed account of the severe financial situation — bad news whose severity came as a shock to the ill-informed board.

A tremendous silence greeted the CRO's announcement. After an awkward moment or two, he asked if anyone had questions. Another moment passed in silence, broken only by farm noises — the lowing of cattle and the rumbling of distant tractors. The CEO started to wrap things up in his overly optimistic way. Finally, a director cut in with a substantive comment.

"Why'd we switch brands of oil?" he asked. "I used to be able to get my oil in easy-pour two-gallon cans. Now it comes in five-gallon pails, and I have to pour it out into smaller cans so I can lift it high enough to pour in my tractor. Who went and did that?"

A discussion of the oil containers used by different petroleum suppliers ensued. Meanwhile it wasn't clear whether Southern States

would make payroll for co-op employees later that week. Later on, however, the director who asked about the oil showed that he wasn't obtuse. In fact, he proved to be an extremely effective board member, and his remark about oil cans was his way of diffusing the tension of the phone conference.

The work of the Southern States board in that case demonstrated that farmers and members of other kinds of co-ops can make excellent corporate directors. They just need the confidence and encouragement to speak up, ask questions, and become informed. Board members inexperienced in the ways of big business enter a fast-paced and unfamiliar environment where they often feel they should know the ropes already. Intimidated by the apparent expertise of others, many are embarrassed to ask questions or defensive at having weaknesses exposed. As a result, they become vulnerable to the errors or manipulations of a few outspoken leaders whose aims may not fully coincide with those of the board as a whole.

Educating the board became an important task at Southern States and constitutes a crucial element in any cooperative's success. Indeed, board assessment and educational programs must occur on a regular, ongoing basis to ensure that new directors receive appropriate training. Fortunately, resources for cooperative boards abound in easily accessible formats.⁶

Member-Board Relations

Besides the issue of expertise in governance, other tensions peculiar to co-ops also affect board performance. Many such tensions arise from the democratic nature of board elections. Members vote for directors on a one-person, one-vote basis in a process more akin to American political contests than to shareholder meetings of C corporations. Like their publicly elected counterparts, cooperative directors must walk a delicate political tightrope between the sometimes conflicting duties of leadership and of representation.

Farmers traditionally join cooperatives for cost savings and operational advantages rather than for investment purposes. Their primary interest lies with their own business, not with the shared enterprise of the co-op, and they benefit through use rather than ownership. Given a choice between high patronage dividends and reinvestment of capital in the cooperative's long-term equity growth, members typically choose the former.

However, while heeding the wishes of their constituents, directors also must attend to the health and longevity of the company in their

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\$165,000,000

Revolving Line of Credit

\$30,000,000

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Effective co-op leadership demands the same kind of selflessness and courage as effective political leadership. In democratic arenas, it's all too easy to play to the crowd.

charge. Learning how to balance the expectations of members with the needs of the cooperative as a business entity in its own right is tricky. One common result is for cooperatives to be underinvested and have much higher debt-to-equity ratios than investor-owned firms, which puts them at higher risk when markets turn sour.

Similarly, it's hard for cooperative boards to make tough decisions that affect fellow members — often their neighbors and friends — in negative ways. Just as Congress has trouble closing military bases or raising taxes, so directors of cooperatives act slowly to restrict the credit of high-risk neighbors, discontinue unprofitable member services, or terminate unsatisfactory member-contracts.

In this respect, the Southern States board showed how courageous leadership can rescue a company from potential disaster. That group performed an ugly task in sacrificing some of its members' interests for the sake of the larger body when it voted to close stores, eliminate unprofitable product lines, and sell certain operations to pay down debt. Elected by regions, directors in the affected areas knew their votes wouldn't be popular and might cost them their prestigious seats on the governing body. In fact, some directors lost elections that year. By this juncture, however, the group also understood the severity of the financial situation, and they knew their actions were necessary to save the co-op.

Effective Leadership

Southern States' success story depends in large part on the transformation of its board into an effective governing body. Effective co-op leadership demands the same kind of selflessness and courage as effective political leadership. In democratic arenas, it's all too easy to play to the crowd. Fortunately, self-serving demagogues rarely gain power over cooperatives. On the other hand, nice, normal folks who don't want to stir up the waters often do. Their reluctance to act decisively on matters of critical financial importance only increases if they don't feel knowledgeable about modern management and business practices.

As important as the education of board members is, however, the mere transmission of information — whether through printed materials or interactive board assessment and training sessions — is not enough. Cooperatives must also take steps, as Southern States did, to broaden the base of their directors by including outside and/or independent members on their boards. The necessary financial expertise will not materialize through even the most diligent study of paper materials or participation in quarterly coaching sessions. Rather, that expertise must be a permanent and vital part of the board itself. In this way, it becomes available to all members through constant discussion and application to live issues.

But the need for education does not belong to the board alone. Since members supply the co-op with its

future leaders, they, too, must understand governance issues — not only the duties of the directors they elect, but also the kinds of concerns, conflicts, and pressures that directors face. The less informed and involved the members at large are, the harder it becomes both to find and to elect good governors. Co-ops then risk failure due to the weakness or manipulation of leaders elevated to power by an apathetic electorate.

The kind of cooperative conduct required to support cooperative businesses is possible only within leadership environments that are characterized by openness and trust. In a setting in which their neighbors are the people affected by their decisions, directors must operate with the fullest possible transparency, in accordance with clear policies that eliminate all odor of favoritism, meanwhile communicating their conclusions and the reasons behind them both to each other and to the membership at large. Within cultures of knowledge, integrity, and free discourse, cooperative boards can turn their characteristic weaknesses into genuine strengths. ■

¹ Land O'Lakes 2004 Annual Report, www.landolakesinc.com/media/2004AnnualReport/letter.asp.

² Ace Hardware, 2004 Annual Report, www.acehardware.com/corp/annrep2004/index.jsp.

³ National Cooperative Business Association (NCBA) statistics as cited in Kimberly Zeuli and Robert Cropp, "Cooperatives: Principles and practices in the 21st century," University of Wisconsin Extension, 1980 (4th ed. 2003), <http://cecommerce.uwex.edu/pdfs/A1457.PDF>.

⁴ Robert Cropp, "Evaluating Board Performance," www.wisc.edu/uwcc/staff/cropp/board.html.

⁵ Jennifer J. Keeling and Colin A. Carter, "Trading Places: Fortunes of California rice co-ops took opposite trajectories; as RGA failed, FRC ascended," *Rural Cooperatives*, May/June 2005, 40.

⁶ The USDA Rural Business-Cooperative Service offers hundreds of reports for all aspects of cooperative businesses, many of which deal with governance issues. The NCBA and university cooperative centers also provide valuable publications for board members. Most of this material is available online.

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