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Introduction to Governance

File C5-70

Governance is an important topic because most value-added agricultural businesses have boards of directors. Governance relates to how the board of directors and managers "govern" the business organization. Regardless of whether the business is organized as a limited liability company (LLC), cooperative or corporation, it has a board of directors (board of managers for LLCs) that are elected by the membership or investors to represent the member's or investor's interest in the company.

Governance of a cooperative is a bit different from governance under the other forms of legal organization. A cooperative's unique business organization is structured to provide benefits to its members through the various marketing and service transactions it provides. Conversely, LLCs and corporations are organized to provide returns to the owners/investors.

First, we will discuss some of the unique governance roles of cooperatives. These are customer, patron, owner and member.

1) **Customer role -** The customer role, which is probably the most important role for agricultural producers, provides the opportunity for producers to sell products, buy production inputs and access production services. The mission of the cooperative is to provide these services.

2) **Patron Role -** A patron is a person who uses the cooperative to buy or sell. For example, a marketing cooperative provides the opportunity for a person to sell a product, regardless of whether it is commodity corn or a specialty type of livestock. Profits of the cooperative are distributed based on patronage (how much the cooperative is used). This is different than other forms of organization where profits are distributed based on the financial investment in the cooperative.

   For a value-added cooperative (new generation cooperative), a person's use of the cooperative (e.g. selling corn to an ethanol business) is maintained in strict proportion to the investment in the cooperative, so the patronage distribution of profits is the same as if the distribution were made based on investment. For example, if a farmer has provided 10% of the investment in a new generation corn-ethanol cooperative, that person would be required to provide 10% of the corn needed by the ethanol facility. The farmer would receive 10% of the profits from the cooperative because it provided 10% of the corn (patronage). Because patronage and investment are in the same proportion, the allocation of profits (10%) is the same as if the profits were distributed based on investment (10%). Many value-added businesses incorporated the use of delivery rights/ requirements early in their history but many have since removed this restriction.

3) **Ownership Role -** There is a unique ownership role. The cooperative member has provided an investment and this investment, along with the patronage returns, are later redeemed by the owner/patron. In other words, equity is allocated back to the membership. This allocation (redemption) is governed by the board of directors based on the by-laws of the cooperative.

4) **Membership Role -** Membership provides the control function of the cooperative. Membership is provided to anyone who uses (patronizes) the cooperative. Control is based on the principle of "one member, one vote" verses "one share, one vote" as with other forms of legal structure. So, control of a cooperative is based on the number of individuals rather the number of shares owned by individuals. Members elect the board of directors at the company's annual meeting and vote on any other issues that are

Reviewed November 2021

brought up at the annual meeting. The directors, through the cooperative's organizational structure, represent the member's interest in the cooperative. A cooperative's board of directors is often structured with geographic regions so that each region selects and has representation from a board member. This is less common for other types of legal organizations.

When we think about these unique roles, the customer role is probably the most important for a cooperative. But the membership role can't be understated. The membership role is the essence of cooperative governance. So when we think about governance, the members elect a board of directors to represent their interest with the cooperative manager.

A cooperative director has a responsibility to represent the membership's best interest. In a cooperative, the manager is not allowed to be on the board of directors, which is not necessarily the case in other legal structures. However, a good business practice is to treat the manager/CEO as if they were a member of the board of directors. So when we think about governance we are thinking about that board and the things they do to govern the organization, or in this case the cooperative.

Principals of Governance

Next let's talk about governance principals. These are broad rules that underlie the business organization of a cooperative. Let's think about a value-added cooperative.

1) **Cooperative benefits -** Benefits arise in a cooperative where net income is distributed to patrons based on earnings. This is a unique role that publicly held organizations or private corporations don't have; the members that use the cooperative are the ones that share the benefits from it. This principle has been the founding principle for cooperatives that still exist today. Over time it has been a very important principle for cooperatives.

2) **Control function -** When we think about cooperative control we think about the democratic principle. Typically cooperatives are represented by the one member, one vote principle. There are cooperatives that represent by volume, but these are not common. So each member has one vote to cast for the board of directors, or any other issue at the annual meeting that affects the membership.

3) **Ownership function -** For LLCs and corporations, the individuals who invest money in the business are the owners of the business. For cooperatives, the individuals who use the cooperative are the owners of the business. Ownership is provided by the patrons who invest in the cooperative. Patrons (the individuals who use the cooperative to buy or sell) who use the cooperative are the individuals who finance the cooperative by providing a portion of their patronage refund as equity. This equity is provided proportional to patronage in the cooperative. So the patrons own the cooperative. This is an important principle of cooperatives.

4) **Other principles -** Other governance principles often relate to things like education. The principle is that the directors have a duty to educate the cooperative patrons and its members about the benefits of the cooperative and its unique organization.

Related Ag Decision Maker Files

File C5-71, The Role of the Board of Directors, www.extension.iastate.edu/agdm/wholefarm/pdf/c5-71.pdf

File C5-72, Recruiting, Selecting and Developing Board Members and Managers, www.extension.iastate.edu/agdm/wholefarm/pdf/c5-72.pdf

File C5-73, Board of Director Evaluations, www.extension.iastate.edu/agdm/wholefarm/pdf/c5-73.pdf

File C5-74, [Business Strategy and the Board of Directors], www.extension.iastate.edu/agdm/wholefarm/pdf/c5-74.pdf

File C5-75, [Governance Issues Unique to Start-up Businesses], www.extension.iastate.edu/agdm/wholefarm/pdf/c5-75.pdf

File C5-76, [Board of Director Educational Needs], www.extension.iastate.edu/agdm/wholefarm/pdf/c5-76.pdf

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