Potential Liability of Directors of Agricultural Cooperatives

by

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The board of directors of an agricultural cooperative is elected by the membership of the cooperative to act as the cooperative's governing body. The board is responsible for the management, operating policies, and supervision of the progress of the business. In carrying out these responsibilities, the directors are often faced with important questions concerning the legality of their actions.

Moreover, some persons asked to serve as directors for agricultural cooperatives are not fully informed or fully aware of the legal responsibilities and liabilities which accompany service as a director. In addition to being personally and legally responsible to the membership, a director can be held personally liable for his actions as a board member. Nevertheless, a candidate for a position on the board of directors of an agricultural cooperative is sometimes told that service on the board will not take much time because the board meets infrequently, operates informally, and the real business of the cooperative is already being managed by key individuals. Actually, the growing burden of director responsibility, the increased assertiveness of members, shareholders, and others, and the present economic conditions all suggest that every director of an agricultural cooperative should be more concerned with the potential personal liability which can result from his actions or the nature of his position.[1]

Cooperatives, like corporations, are viewed in law as

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1. Because of the great number of directors of cooperatives who are male, and for the sake of brevity, this work will refer to individual directors pronominally as "he."

business organizations. They are usually incorporated under state law. However, cooperatives differ from other corporations most notably in their purpose: to achieve economies for their members and patrons through collective efforts. Otherwise, with a few significant exceptions, the cooperative functions in the same manner as a profit oriented corporation. More importantly, the cooperative director serves substantially the same purpose as directors of other corporations. These similiarities have resulted in the ready application by the courts of the principles of corporate law to cases involving cooperatives and their directors. Furthermore, courts and legal scholars resort to corporate analogy when there is a question about cooperatives and no relevant cases are available. This study therefore uses considerable corporate analogy, as well as specific legal principles applicable to cooperatives, to review and analyze the subject of director liability.

There are relatively few cases which deal specifically with director liability in the cooperative enterprise. This may be the result of one or more of several factors: reluctance to sue fellow members and directors, a lack of knowledge about rights, the uncertain state of the law, and the difficulty in obtaining a judgment finding directors personally liable for their actions. However, this situation could quickly change. An attempt has been made in this study to anticipate an increase in lawsuits against directors of cooperatives by reviewing those situations where cooperative directors have already become involved in lawsuits and by analyzing and applying specific cooperative and corporate law to those situations where there has been little or no litigation against cooperative directors. This study will also identify those areas of legal liability where cooperative directors are treated differently than corporate directors.

I. HOW DIRECTORS ARE SUED

Although there can be many reasons for bringing a civil or criminal action against a director, there are basically four ways in which a director can be sued or prosecuted. First, a criminal action may be brought in the public interest by fed-

eral, state, or local authorities. Second, a civil suit may be brought by a third party, such as a person who contracted with or bought something from the cooperative. Third, a director could be sued by the cooperative that he serves through action by a majority of the other directors. Fourth, any stockholder may bring a derivative action against a director on behalf of and for the benefit of the cooperative.[2]

Specifically, some of the reasons that directors are sued or prosecuted include: violation of statute, violation of bylaws or articles of incorporation, fraud, negligence, commission of other torts or crimes, anti-trust violations, securities laws violations, misappropriation or misuse of the assets and property of the cooperative, authorization of preferential treatment to directors, speculation on the commodities markets, payment of patronage refunds in cash exceeding current savings, failure to require financial statements with resulting injury to the business, failure to give annual reports to members, participation in illegal political activity, participation in contracts with the cooperative that differ from its contracts with other parties, failure to attend board meetings to the extent that the cooperative suffers financial problems as a result of inattention, possession of a property interest adverse to the cooperative, operation of a business which competes with the cooperative, and failure to adequately insure the cooperative's assets or obligations.

It is important to note, however, that in most cases where the cooperative and its directors are sued, the cooperative may be hurt financially and may have to change its operations as a result of the suit, but it is not likely that the directors will be held personally liable for their actions. At least, this has been the situation in the past.

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2. *See* D. DEWEY, LEGAL RESPONSIBILITIES OF DIRECTORS OF AGRICULTURAL COOPERATIVE ASSOCIATIONS 13 (Wichita Bank for Cooperatives 1975 rev. and reprint 1980). The booklet is an excellent source of basic information on the topic of director liability. The author of this booklet considers the stockholder's derivative action to be by far the most significant type of litigation in this area of director liability.

A. Common Law Liability

Common law liabilities are based on judge-made doctrines which often have preceded statutory enactments and are still recognized as sources of liability. A full examination of the many state statutes on director liability is beyond the scope of this study. However, the common law doctrines that are the source of much litigation concerning directors are nearly universal, and they are reviewed in this section.

1. Fiduciary Duty

A director owes a fiduciary duty to the cooperative, to its members, to other directors, and occasionally to the cooperative's creditors. The status of a fiduciary signifies a special relationship between the director and the cooperative, characterized by trust and confidence in the director and by the director's integrity and candor toward the cooperative. As a fiduciary, the director is obliged to act prudently and primarily for the benefit of the cooperative and to avoid benefiting himself or prejudicing the cooperative unless he has first made complete disclosure and obtained consent. The director has by virtue of his position assumed a fiduciary duty and is therefore liable for damages resulting from a breach of the duty. There are three principal aspects of the director's fiduciary duty: loyalty, due care, and obedience.

a. *Loyalty*

A director's duty of loyalty is the most comprehensive and most often litigated of the fiduciary duties. It includes a duty of undivided loyalty, a duty to forego seizure of the cooperative's business opportunity, a duty to refrain from conflicts of interest, and a duty of honesty and good faith. These duties are owed to all members and shareholders, to the cooperative as an entity, to other directors, and may extend to the cooperative's general creditors.[3]

3. First Nat'l Bank of LaMarque v. Smith, 436 F. Supp. 824 (S.D. Tex. 1977) (cites the general rule, applying it strictly to a bank director); Lawson v. Baltimore Paint & Chemical Corp., 347 F. Supp. 967 (Md. 1972) (holding that directors owed a fiduciary duty to the corporation and its stockholders); Parish v. Maryland & Virginia Milk Producers Ass'n, 250 Md. 24, 242 A.2d 512 (1968) (where members of a milk

Breaches of the duty of undivided loyalty can occur if the director prefers one group of members over another group, or if he disregards the interests of any one group of members.[4] With regard to his personal interests, a director may take no special advantages not available to the membership of the cooperative.[5]

Additionally, the duty of loyalty prohibits a director from appropriating opportunities which properly belong to the cooperative.[6] The difficulty is in identifying which opportunities are rightfully the cooperative's and therefore prohibited to directors. To be considered as belonging to the cooperative, the opportunity must be one that it could and would take for itself if given the chance.[7] But if the opportunity has been rejected in good faith by the cooperative for reasons of financial or other disability, and there has been no misrepresentation by the director, he may pursue the opportunity as his own.[8]

Conflicts of interest between the director and the cooperative can occur rather easily. In general, a conflict exists if the director uses his position or the cooperative's assets for

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producer's coop. had standing in a derivative suit charging directors, *inter alia*, with a breach of fiduciary duty). *See also* Dannen v. Scafidi, 75 Ill. App. 3d 10, 393 N.E.2d 1246 (1979). *Cf.* Newton v. Hornblower, Inc., 224 Kan. 506, 582 P.2d 1136 (1978) (in which managing directors charged with self-dealing had breached the strict fiduciary duty owed to the corporation, shareholders, and other directors).

4. *See* Box v. Northrup Corp., 459 F. Supp. 540 (S.D.N.Y. 1978); Farber v. Servan Land Co., 393 F. Supp. 633 (S.D. Fla. 1974).

5. *See, e.g.*, Fisher v. Pennsylvania Life Co., 69 Cal. App. 3d 506, 138 Cal. Rptr. 181 (1977). Furthermore, questions of divided loyalty may occur where there are interlocking directorates, with two organizations having a majority of directors in common. *See, e.g.*, Wisconsin Ave. Associates v. 2720 Wisconsin Ave. Coop. Ass'n, Inc., 441 A.2d 956 (D.C. App. 1982) (former directors of a housing coop. were sued by members for breach of fiduciary duty and court stated the rule that acts of common directors on behalf of both businesses are presumed fraudulent).

6. *See* Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979); Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997 (1981); *see also* Comm. on Corp. Laws, *Corporate Director's Guidebook*, 33 BUS. LAW 1595, 1600 (1978). This duty rests on the theory that a business opportunity is an asset of the business.

7. *See* Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939); Goldenrod Mining Co. v. Bukvich, 108 Mont. 569, 92 P.2d 316 (1939). Some states require an expectancy interest in the opportunity for the coop. to claim it. *See* Lincoln Stores, Inc. v. Grant, 309 Mass. 417, 34 N.E.2d 704 (1941).

8. *See supra* note 6.

personal gain, causing a breach of the fiduciary duty of loyalty.[9] A director has the obligation, where he is aware that a conflict of interests exists, to disclose that fact.[10] Conflicts may include a director's owning or operating a competing business, using his position to blunt the cooperative's competitive effort for the benefit of another enterprise, and sitting on more than one board.[11]

Another area where conflicts of interest occur is in business transactions between the director and the cooperative. In view of the constraints against taking special advantage or profiting by the director's position, self-dealing by a director may be a breach of the duty of loyalty.[12] When transacting business with the cooperative, a director must disclose his interest and not retain unfair or secret profits.[13]

Finally, the fiduciary duty of loyalty raises an obligation to act honestly and in good faith.[14] The duty of honesty prohibits deeds such as misappropriation of cooperative assets, a director's sale of his influence with the board, undisclosed profits or commissions, or any other act of dishonesty which harms the cooperative or secretly enriches the director.[15] The duty of good faith prohibits the director from

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9. Jackson v. Ludeling, 88 U.S. (21 Wall.) 616 (1874); Fleishhacker v. Blum, 109 F.2d 543 (9th Cir. 1940); MacEwen v. Star Kist Foods, Inc., 251 F. Supp. 33 (E.D.N.Y. 1966); Levin v. Levin, 43 Md. App. 380, 405 A.2d 770 (1979); Seaboard Industries v. Monaco, 442 Pa. 635, 276 A.2d 305 (1971).

10. Berkman v. Rust Craft Greeting Cards, Inc., 454 F. Supp. 787 (1978).

11. Torea Land & Cattle Co. v. Linsenmeyer, 100 Ariz. 107, 412 P.2d 47 (1966); Evangelista v. Queens Structure Corp., 27 Misc. 2d 962, 212 N.Y.S.2d 781 (1961); and Note, *Corporations—Duty of Loyalty and Corporate Opportunity—Transactions Between Corporations With Common Directors*, 43 TENN. L. REV. 155 (1975).

12. *I.e.*, self-dealing is a transaction wherein the director's self-interest is opposed to his duty. *See also* Pepper v. Litton, 308 U.S. 295 (1939) (holding that where self-dealing appears, the burden is on the director to prove his good faith and the fairness of the transaction). *Cf.* West v. Camden, 135 U.S. 507 (1890).

13. Simpson v. Spellman, 522 S.W.2d 615 (Mo. App. 1975); *cf.* Loy v. Lorm Corp., 278 S.E.2d 897 (N.C. App. 1981) (finding a *prima facie* case of breach based on an allegation that the interlocked director drained Business A to benefit closely-held Business B).

14. *Cf.* A & K R.R. Materials, Inc. v. Green Bay & W. Ry., 437 F. Supp. 636 (E.D. Wis. 1977); Salvadore v. Connor, 87 Mich. App. 664, 276 N.W.2d 458 (1978); Lake Harriet State Bank v. Venie, 138 Minn. 339, 165 N.W. 225 (1917).

15. Monterey Water Co. v. Voorhees, 45 Ariz. 338, 43 P.2d 196 (1935); 3 W.

committing or even condoning fraud.[16] Good faith requires a director to behave toward the cooperative with the utmost fidelity and fairness, a standard stricter than that demanded in arm's-length marketplace relations.[17] The director must act with the intention of benefiting the cooperative.[18]

b. *Due Care*

A director owes a fiduciary duty of due care to the cooperative. The standard of conduct in state law may be phrased in terms of diligence or reasonable care, but the standard of due care under Section 35 of the Model Business Corporation Act (hereinafter referred to as MBCA) is defined as that degree of skill, diligence, and care which ordinarily prudent men would exercise in similar circumstances in like positions.[19] Section 35 provides a flexible standard of conduct for both professional and non-professional directors, while still requiring the exercise of due care's essential feature: prudence.[20]

Under this standard, the exact limits of the duty are defined by the circumstances and needs of the particular business, the type of business, and customs and usage in the business.[21] The director's failure to use the degree of care required by the particular situation can result in his liability

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FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 860 (rev'd perm. ed. 1975); and Simpson v. Spellman, *supra* note 13.

16. Salina Mercantile Co. v. Stiefel, 82 Kan. 7, 107 P. 774 (1910).

17. Elizey v. Fyr-Pruf, Inc., 376 So. 2d 1328 (Miss. 1979), *citing* Cardozo, J., in Meinhard v. Salmon, 249 N.Y. 458, 459, 164 N.E. 545, 546 (1928), ". . . the duty of the finest loyalty . . . not honesty alone but the punctilio of an honor the most sensitive is then the standard of behavior."

18. *See In re* County Green Ltd. Partnership, 438 F. Supp. 701 (W.D. Va. 1971).

19. 3A FLETCHER, *supra* note 15, at § 1037. Other standards are Delaware's ordinarily prudent director, similar position, similar circumstances; *see* Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963); and the now altered but formerly strict Pennsylvania rule: ordinarily prudent men, same or similar circumstances, in conduct of *own* affairs (emphasis added), *see* Seaboard Industries, Inc. v. Monaco, *supra* note 9. The MODEL BUSINESS CORP. ACT § 35 (1969) (hereinafter cited as M.B.C.A.) is widely adopted as a codification of states' common law.

20. M.B.C.A. § 35 comment 44 (1969) (ordinary prudence means common sense, practical wisdom, *informed judgment* (emphasis added)).

21. *See* Blaustein v. Pan Amer. Petroleum & Transport Co., 293 N.Y. 281, 56 N.E.2d 705 (1944); Neese v. Brown, 218 Tenn. 686, 405 S.W.2d 577 (1964).

for losses suffered by the cooperative.[22] The duty of due care requires the exercise of independent judgment which is vigilant, skeptical, scrutinizing, and at all times honest and unbiased.[23]

While the director is not normally expected personally to operate the cooperative, he has the duty of delegating responsibility and monitoring performance—a duty of prudent selection and adequate supervision—as a function of the duty of due care.[24] It is no defense to breaches of this duty that a director was a mere figurehead or that he was not compensated.[25] Further, as a part of this duty, a director is presumed to have knowledge of the contents of the cooperative's books and records,[26] and to have knowledge of his duties.[27]

Corresponding with a director's duty of due care is his right to rely on certain parties and information. Assuming that he has no knowledge to the contrary which would make reliance unwarranted, a director may rely on the advice of counsel, officers, or employees whom the director reasonably believes to be competent, public accountants, other experts, and committees of the board.[28] Reasonable reliance on the

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22. Lippitt v. Ashley, 89 Conn. 451, 94 A. 995 (1915).

23. W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 26-27 (1978). *See Corporate Director's Guidebook*, *supra* note 6, at 1599. To provide a basis for judgment, a director must remain alert to developments and circumstances demanding inquiry. *See* United States v. Cooperative Grain & Supply, 426 F.2d 47 (8th Cir. 1973). *See also* Lanza v. Drexel Co., 479 F.2d 1277 (2d Cir. 1973).

24. *See* W. KNEPPER, *supra* note 23, at 113-14.

25. Goldenrod Mining Co. v. Bukvich, *supra* note 7. *See also* Bowerman v. Hamner, 250 U.S. 504 (1919).

26. Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). Ignorance of records or duties is no defense if it results from inattention, negligence, or shirking responsibility, in short, if it results from a failure to exercise due care in the director's acquainting himself with the job and the coop.'s business matters. *See* Olin Mathieson Chem. Corp. v. Planters Corp., 236 S.C. 318, 114 S.E.2d 321 (1960).

27. 19 AM. JUR. 2d *Corporations* § 1279 (1965).

28. *See* Harves & Sherard, *Reliance on Advice of Counsel as a Defense in Corporate and Security Cases*, 62 VA. L. REV. 1 (1976); M.B.C.A. § 35. *See also Comment on Amendments to § 35 of the Model Business Corporation Act*, 32 BUS. LAW. 42 (1976) (requiring that a director be diligent in assuring the reliability of sources); Gilbert v. Burnside, 13 A.D.2d 982, 216 N.Y.S.2d 430 (1961) (absolute defense).

statements, opinions, or reports from these sources satisfies the fiduciary duty of due care.

Because a director is required to make numerous decisions, despite all reasonable precautions some error is bound to occur. As a result, the so-called business judgment rule has developed. This rule prevents a director's liability for business losses when he performs his duties in good faith, for the best interests of the business, and with the exercise of unbiased, independent judgment. The business judgment rule recognizes that a director is not an insurer of business success and that he binds himself to do only what reasonably can be done.[29] Underlying the rule is a recognition that without allowance for honest error no director could afford the risk of liability associated with his position.[30] Several states have codified a form of the business judgment rule.[31] Codification of the rule also occurs in those states which have adopted Section 35 of the MBCA.

c. *Obedience*

The third principal fiduciary duty to which a director will be held is the duty of obedience. A director must comply with the cooperative's charter, articles of incorporation, and bylaws, as well as with statutes and contracts. The duty of obedience arises from the director's role as an agent for the cooperative.[32] Accordingly, the director may only act within the limits of the power he has been given.

Illustrating the requirements of the obedience duty is the case of *Fagerberg v. Phoenix Flour Mills Co.*[33] Part of the plaintiff mill's operations included entering the wheat fu-

29. McEwen v. Kelly, 140 Ga. 720, 79 S.E. 777 (1913). *See also* Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (1944); Nursing Home Bldg. Corp. v. DeHart, 535 P.2d 137, 144 (Wash. 1975).

30. On the other hand, even where there is no fraud, self-dealing, or personal profit, a director will not be relieved of liability by the business judgment rule where loss to the cooperative is caused by imprudence, wastefulness, or carelessness. Selheimer v. Manganese Corp. of America, 423 Pa. 563, 224 A.2d 634 (1966).

31. *See, e.g.*, N.M. STAT. ANN. § 76-12-14 (1978); N.D. CENT. CODE § 10-15-31 (Repl. 1976); *cf.* WIS. STAT. § 185.37(1) (1957).

32. Lexington Mill & Elevator Co. v. Browne, 116 Neb. 753, 219 N.W. 12 (1928).

33. 50 Ariz. 227, 71 P.2d 1022 (1937). *See also* Wells v. Neill, 162 Miss. 30, 138 So. 569 (1932) (cotton futures).

tures market for legitimate hedging purposes. This task was entrusted to two corporate directors who went beyond their assignment and secretly used hedging funds to buy futures on margin as a speculation. Large losses resulted. In an action against the directors, the court held that the directors had engaged in unauthorized and *ultra vires* activity which resulted in their joint and several liability for the loss.

Other examples of *ultra vires* acts for which directors have been held liable include engaging in a line of business not authorized in the bylaws,[34] making payments to silence complaints of unlawful business activity,[35] causing depreciation of stock value by *ultra vires* acts,[36] and publication of a libel.[37]

The party to whom the director owes the duty of obedience will vary depending on the conduct in question. If the conduct involves a failure to obey a positive commandment, or nonfeasance, the duty of obedience is owed only to the cooperative and gives no cause of action to third parties. But if the conduct is the wrongful doing of some permissible act, or misfeasance, the director may be directly liable to the person injured, including the cooperative or a third party.[38] Nevertheless, a director may be relieved of liability to the cooperative when his actions are ratified by all voting members, whether ratification is prior or subsequent to the action, so long as there is notice and disclosure.[39]

2. Negligence

A director may also be exposed to a suit at law for the

34. Cooper v. Hill, 94 F. 582 (8th Cir. 1899) (bank engaging in coal mining).

35. Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351 (1909) (operating on a Sunday).

36. Holmes v. Crane, 191 A.D. 820, 182 N.Y.S. 270 (1920) (holding that directors could be liable directly to the stockholder, even when not liable to the corporation itself).

37. Hill v. Murphy, 212 Mass. 1, 98 N.E. 781 (1912).

38. 2 W. FLETCHER, *supra* note 15, at § 449 (rev. perm. ed. 1982). Particularly, a third party who has no further knowledge is entitled to rely on the director's apparent authority and hold the director liable for misfeasance *ultra vires*.

39. Sommers v. Apalachicola N. R.R., 85 Fla. 9, 96 So. 151 (1922). This defense is only available against the cooperative and not against others, such as a trustee in bankruptcy. *See* Neese v. Browne, 218 Tenn. 686, 405 S.W.2d 577 (1964).

tort of negligence as a result of his official actions or omissions to act which cause injury to the cooperative or a third party. Suits for negligence are alternative to actions in equity for breach of fiduciary duty, though the two causes of action may be based on the same set of facts and circumstances. Plaintiffs who seek punitive damages or wish to avoid equitable defenses will choose the action at law. However, they must then prove the necessary elements of the tort of negligence: a duty of conduct owed by the director; his failure to conform to the standard of conduct, or breach of duty; a causal link between the breach and resulting injury; and actual loss or damage to the plaintiff.[40]

The most obscure aspect of negligence is the standard of conduct which a director must observe in order to avoid liability. The standard has been referred to at different times as "gross" negligence, "ordinary" negligence,[41] or conduct which fails to meet the requisite standard of care.[42] When applied to cases involving directors, however, the distinctions between these standards seem to have vanished. Since almost every case of negligence must be evaluated on its own particular circumstances, the standard of care is a question of fact rather than law.[43] Liability may be more realistically assessed by considering the areas of conduct in which directors owe a duty of care.

Affirmatively speaking, a director has a duty of care and diligence in administering the cooperative and safeguarding its assets. The director has ultimate responsibility, but may delegate specific tasks. He may select trustworthy officers and employees, but he must maintain some supervision and oversight of their activities. The director can be held liable for the wrongful acts of employees or officers if the director

40. *See* RESTATEMENT (SECOND) OF TORTS § 281 (1965).

41. W. PROSSER, HANDBOOK OF THE LAW OF TORTS 181 (4th ed. 1971).

42. The widely adopted M.B.C.A. § 35 requires directors to act "with such care as an ordinarily prudent person in a like position would use under similar circumstances."

43. That is, the judge's or jury's sense of justice will supply the prevailing community standard, so it is unavailing in avoiding liability to be overly exact concerning the phrasing of the standard of care. *See* W. PROSSER, *supra* note 41, at 684: "The prevailing view is that there are no degrees of care or negligence, as a matter of law."

has been negligent in their selection or supervision.[44]

In *Parish v. Maryland & Virginia Milk Producers Ass'n*,[45] directors were charged with negligence for improper supervision of officers. After they were put on notice that certain officers had breached their fiduciary duties, they failed to act against those officers. The directors' duty to act was owed both to the cooperative and to third parties harmed by the acts of its agents, because the harm could have been prevented by the directors' diligence.[46]

While a director need not be personally involved in operating the business of his cooperative, he does have a management duty. He fails to discharge diligently that duty if he repeatedly misses board meetings or otherwise avoids paying attention to the cooperative's activities.[47] It is no defense for the director to claim that he was a mere figurehead[48] or that he was ignorant, if his ignorance results from a failure to be diligent.[49]

In connection with the management duty, diligence requires in some instances that the director investigate certain matters, such as proposed transactions of the cooperative or the known questionable character and activities of agents. A director must also review and be familiar with the contents of reports, books, and records of the cooperative in order to be aware of significant developments and as a means of verifying oral representations of others.[50] Again, *Parish v. Maryland & Virginia Milk Producers Ass'n*[51] is a useful example. Most of the directors' misdeeds in this case were the result of a blind or unjustified reliance on the representations of un-

44. Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341 (1965).

45. 250 Md. 24, 242 A.2d 512 (1968).

46. *See* W. KNEPPER, *supra* note 23, at 47. Directors must indemnify their corporations for losses caused by the directors' culpable negligence. *See also* Note, Corporations—Officers and Directors—Figurehead Director Liable for Co-Director's Misappropriation of Funds, 12 SETON HALL L. REV., 581 (1982) (discussing Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981)).

47. Martin v. Hardy, 251 Mich. 413, 232 N.W. 197 (1930).

48. Thisted v. Tower Management Corp., 147 Mont. 1, 409 P.2d 813 (1966).

49. Bowerman v. Hamner, 250 U.S. 504 (1919).

50. DePinto v. Provident Security Life Ins. Co., 374 F.2d 37 (9th Cir. 1967), *cert. denied*, 389 U.S. 822 (1967).

51. *See supra* note 3.

faithful officers. Some of the directors' mistakes, however, were outright abdications of responsibility, such as when they approved the purchase of an overpriced dairy, clearly violating antitrust laws, and then sold the dairy at a price substantially below its value and without security. Liability for the dairy transaction was based on the directors' presence at the meetings where these actions were approved, and the absence of their dissent in the minutes.

Additionally, directors' liability can result from misfeasance, such as when loss is caused by acts of incompetence or recklessness. One example of this type of conduct is failure to make an accurate statement when registering securities. The director owes a duty to securities owners to accurately report the cooperative's state of affairs and can be held liable for negligently disclosing untrue information or failing to include material facts in the registration statement.[52] Failure to conform to statutory duties has also been held to be negligence as a matter of law, causing liability independent of that arising from failure to observe the non-statutory duty of diligence.[53] Presumably, this principle of negligence liability resulting from violation of a statutory duty might even be extended to violations of a cooperative's bylaws or articles of incorporation.

A director may ordinarily avoid liability for negligence by participating in meetings and remaining attentive. Still, he may make a business decision that causes a loss to the cooperative or its members. If the director has acted diligently and in good faith, and the loss results from an honest mistake of independent judgment, the director may be protected by the business judgment rule.[54] While this rule generally allows directors to exercise discretion free from the worry that their decisions will be second-guessed by the courts, it has limited applicability to some types of viola-

52. *See* the section of this paper concerning securities for a discussion of requirements and liabilities.

53. Precision Extrusions, Inc. v. Stewart, 36 Ill. App. 2d 30, 183 N.E.2d 547 (1962); *but cf.* Roussel Pump & Elec. Co. v. Sanderson, 216 So. 2d 650 (La. App. 1968).

54. *See supra* notes 29-31 and accompanying text; *see also* Hanson v. Ontario Milk Producers Coop., Inc., 58 Misc. 2d 138, 194 N.Y.S.2d 936 (1968).

tions.[55] Yet even allegations that a director's fiduciary duty has been breached may sometimes be defeated by the business judgment rule.[56] In any event, the business judgment rule is not a direct defense against liability for acts of negligence. Instead, the rule operates to prevent the exercise of honest judgment from being chargeable as negligence.[57]

Another barrier to imposing liability for negligence is the requirement of causation. A director may breach his duty and still not be liable to the plaintiff unless the breach was the proximate cause of the plaintiff's loss. Though some courts may employ reasoning generous to deserving plaintiffs, not every breach of duty followed by loss will support a cause of action in negligence.[58]

Perhaps equally important, if a director has the misfortune to commit an act of negligence which causes a loss to the cooperative, he may seek to have his act ratified by the voting membership. This could be a reasonable course of action for the membership if it would be fruitless or self-defeating to sue the director. This is especially true since it is usually better to devote valuable resources to the cooperative's business rather than to futile litigation.[59]

3. Intentional Torts

A director can also be held liable for intentional torts committed while the director was acting in his official capacity. As an agent of the cooperative, the director is liable when he injures third parties even though he acts on behalf

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55. W. KNEPPER, *supra* note 23, at 21; *e.g.*, violations of federal securities, antitrust, or labor laws.

56. *See* Grossman v. Johnson, 89 F.R.D. 656 (Mass. 1981).

57. The rule can therefore help a director avoid costly litigation. *See, e.g.*, the use of the business judgment rule to dismiss a derivative suit in Lasker v. Burks, 404 F. Supp. 1172 (S.D.N.Y. 1975), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).

58. *See* Allied Freightways v. Cholfin, 325 Mass. 360, 91 N.E.2d 765 (1950); *see also* Brown v. Estes, 374 So. 2d 241 (Miss. 1979).

59. Ratification will act to estop further suits in the right of the cooperative or by trustees and creditors in bankruptcy. Field v. Lew, 184 F. Supp. 23 (E.D.N.Y. 1960); and Cunningham v. Jaffe, 251 F. Supp. 143 (S.C. 1966); *but cf.* Neese v. Brown, 218 Tenn. 686, 405 S.W.2d 577 (1964).

of the cooperative.[60] The director is also directly liable to the cooperative when his actions toward it are tortious.

One of the torts for which directors can be charged by both third parties and the cooperative is deceit or misrepresentation.[61] Actions such as issuing checks against insufficient funds,[62] making misrepresentations about security backing bonds,[63] refusing to return fraudulently obtained money after learning of the misrepresentation,[64] negligently making false representations,[65] and making misrepresentations to creditors[66] have all resulted in director liability. Misrepresentations to the cooperative can even occur by nondisclosure, which really amounts to misleading by silence.[67] The director, to remain free from liability for fraud or deceit, must avoid making negligent or knowingly false misrepresentations, either by assertion or omission, designed to make another person act in reliance on the assertion or omission.

Directors of agricultural cooperatives that process or handle agricultural products may need to guard against liability for nuisance. If the cooperative's activities interfere with the enjoyment or reduce the value of affected neighboring property, the director can be held personally liable on the theory that he has direction and control of the business.[68]

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60. The director is liable to exonerate the coooperative when it is held liable in agency for his tortious act. *See* Hill v. Murphy, 212 Mass. 1, 98 N.E. 781 (1912). It is no defense that he was acting as the cooperative's agent. *See* Chandler v. Hunter, 340 So. 2d 818 (Ala. App. 1976) and RESTATEMENT (SECOND) OF AGENCY § 343 (1958).

61. Often joined or confused with the broader term fraud, deceit is a distinct and narrow action at law. According to Dean Prosser, fraud is "a term so vague that it requires definition in nearly every case." *See supra* note 41, at 684. For fraud, equitable relief is usually the appropriate remedy.

62. *See, e.g.*, 47 A.L.R.3d 1250, personal liability of officers or directors of corporation for corporate checks issued against insufficient funds.

63. Paul v. Cameron, 127 Neb. 510, 256 N.W. 11 (1934).

64. Hough v. Commercial Wheat Growers Co., 212 Ill. App. 306, 313 (1918).

65. Cameron v. Outdoor Resorts of Am., Inc., 611 F.2d 105 (5th Cir. 1980); *but cf.* Marine Midland Bank v. John E. Russo Produce Co., 50 N.Y.2d 31, 427 N.Y.S.2d 961 (1980).

66. Wilson v. Appalachian Oak Flooring & Hardware Co., 220 Ga. 599, 140 S.E.2d 830 (1965); *see also* Cargill, Inc. v. American Pork Producers, Inc., 426 F. Supp. 499 (D.S.D. 1977).

67. McDonough v. Williams, 77 Ark. 261, 92 S.W. 783 (1905).

68. *See, e.g.*, Nunnelly v. Southern Iron Co., 94 Tenn. 397, 29 S.W. 361 (1895),

There is a possibility that, in the course of handling members' products or dealing with goods owned by another, the tort of conversion may occur. A not uncommon example is the sale of stored grain without the member/owner's consent or at a price lower than promised.[69] In one case, directors faced liability when they approved a chattel mortgage of farm machinery in which the plaintiff had reserved title.[70] The directors' vote for or signing of the mortgage was sufficient participation in the conversion to create liability. In addition to liability based on direct participation, directors can be held liable for knowingly condoning the conversion or for negligently failing to prevent it.[71]

4. Conclusion on Common Law Liabilities

The common law liabilities to which directors of agricultural cooperatives may be subject are an expression of the high standard of conduct which directors must observe. The fiduciary duties of loyalty, due care, and obedience are part of the director's role as steward of the cooperative, and they place on him heavy burdens of personal risk for failure to comply with these duties. Nevertheless, liability may be avoided by resisting all temptations to improve one's own lot at the expense of the cooperative and by exercising the highest quality of care in official matters.

B. Criminal Violations

There has been a trend in recent years to fix criminal liability on corporate decisionmakers. Environmental consciousness, the growth of government regulation, and a heightened public sense that responsible persons in the business organization should account personally for violations committed in the conduct of the business have all combined

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where controlling officers ignored the plaintiff's complaints that the defendants' activities polluted a stream flowing through his lands, resulting in defendants' joint personal liability.

69. Lowell Hoit & Co. v. Detig, 320 Ill. App. 179, 50 N.E.2d 602 (1943).

70. Aeroglide Corp. v. Zeh, 301 F.2d 420 (2d Cir. 1962).

71. Frontier Milling & Elevator Co. v. Roy White Coop. Mercantile Co., 25 Idaho 478, 138 P. 825 (1914).

to place directors in an increasingly vulnerable position. A special group of crimes, "public welfare" offenses, has developed which dispenses with the traditional scienter (guilty knowledge) requirement for criminal liability. Part of this development includes the doctrine of the responsible corporate official, which dictates that the official will be found liable along with the business organization itself. This doctrine reflects the strong public policy that the health and safety of the public take precedence over burdens on businesses and the individuals who control them.

1. Public Health and Environment

One case which especially serves to put directors of cooperatives on notice concerning their potential criminal liability in the area of public health and environmental violations is *United States v. Park*.[72] In *Park*, the defendant was the president of a business that stored food in warehouses. Inspectors found violations of the Federal Food, Drug and Cosmetic Act (FDCA).[73] These violations were reported to the defendant, who ordered remedial action. When reinspection showed that unsanitary conditions continued, the defendant was charged with criminal violation of the FDCA. The defendant argued that he had done all he could and had discharged his obligations by ordering reliable employees to cure the violations. The United States Supreme Court held that the defendant was criminally liable since he had a responsible relationship to the situation causing the violations and could have prevented it. Liability was based on the defendant's position and authority and on his duty under the FDCA to exercise the highest standard of foresight and vigilance.[74] The court dispensed with any re-

72. 421 U.S. 658 (1975).

73. 21 U.S.C.A. §§ 301-392 (West 1972). Section 331 prohibits introduction or receipt in interstate commerce of adulterated or misbranded food, or the adulteration or misbranding of food; Section 333 prescribes penalties and allows a defense of good faith; Section 342 defines adulterated food.

74. 421 U.S. at 673, 674. The readiness to prosecute in food contamination cases emphasizes the risk for directors of agricultural cooperatives. *See, e.g.*, United States v. Y. Hata & Co., 535 F.2d 508 (9th Cir. 1976), *cert. denied*, 429 U.S. 828 (1976) (birds contaminated rice in warehouse); United States v. Starr, 535 F.2d 512 (9th Cir. 1976)

quirement that the defendant be aware of wrongdoing.[75]

While not all directors of cooperatives will find themselves in a position of control like that of Park, who was the chief executive officer, the principle of the "responsible corporate official" as set out in this case makes it crucial that directors properly supervise officers and employees and see that rules on avoiding and correcting FDCA violations are observed.

Similarly, violations of other special statutes and rules may result in director liability. The Poultry Products Inspection Act makes it unlawful to deal in misbranded or adulterated poultry products and states that "any person" who violates its provisions is criminally liable.[76] The Wholesome Meat Act creates numerous responsibilities for processors of cattle, sheep, swine, and the like.[77] The Clean Air Act has an express provision that responsible corporate officers may be held liable for knowing violations of regulatory orders or standards of performance, or for making false statements involving air pollution.[78] The Federal Water Pollution Control Act (FWPCA) provides that willful or negligent violations of its sections relating to effluents, standards of performance, toxic pollutants, permit conditions, and record keeping are punishable as criminal offenses.[79] Liability

(mice infested food warehouse); United States v. Acri Wholesale Grocery Co., 409 F. Supp. 529 (S.D. Iowa 1976) (feline and rodent contamination in foodstuffs).

75. *Id.* at 672, 673. The Court imposed a stricter standard than the conduct permitted under common law negligence. *See* Stewart, J., dissenting, arguing that to find criminal liability under FDCA requires evidence beyond a reasonable doubt showing conduct amounting at least to common law negligence. However, the Court did acknowledge that a defense could be pleaded that the defendant was powerless to prevent or correct the violation. *Id.* at 673, 674. *Cf.* United States v. New England Grocers Supply Co., 488 F. Supp. 230 (D. Mass. 1980) (holding that mere position is not enough to cause liability under FDCA).

76. 21 U.S.C.A. §§ 451-470 (West 1972). *See* 21 U.S.C.A. § 461 (West 1972).

77. 21 U.S.C.A. §§ 601-695 (West 1972). Violations by "any person" are criminal offenses, 21 U.S.C.A. § 676 (West 1972).

78. 42 U.S.C.A. §§ 7401-7626 (West 1983). *See id.* at § 7413(c). This act has an exemption for country elevators of less than two and one-half million bushels capacity, *id.* at § 7411(i); *see also* 40 C.F.R. 60.300 (1982). The act also provides for civil liability and a private right of action in civil cases, *id.* at § 7413(b); *see also id.* at § 7604.

79. 33 U.S.C.A. §§ 1251-1376 (West 1978); *see id.* at § 1319(c). It is specifically provided that responsible corporate officers may be held liable, *id.* at § 1319(c)(3).

for water pollution can also occur under the Refuse Act which prohibits pollution of, or the dumping of debris into, navigable waterways.[80] Cooperatives involved in the distribution and application of insecticides, fungicides, and rodenticides are within the authority of the Federal Insecticide, Fungicide and Rodenticide Act (FIFRA) which provides that a distributor who knowingly violates its provisions is subject to criminal liability.[81] The Consumer Product Safety Act regulates possibly injurious products and specifically provides for director liability in the event of a willful violation.[82] Finally, the Toxic Substance Control Act (TSCA) is intended to control the use of chemicals not already covered by FIFRA.[83]

While some of these statutes have no express provision for applying the principle of "responsible corporate official," actions which imperil the public health and safety may be attributed to responsible directors under the rule of *Park*. Certainly, absence of specific provisions about responsible persons in management should not prevent application of the *Park* doctrine.[84]

2. Other Criminal Liability

There are numerous acts in addition to the public welfare offenses which are proscribed and punished as criminal offenses. The concept of the responsible corporate official is

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Although there is an exemption for nonpoint agricultural sources of pollution, it is meant to apply to material leaving agricultural land in a diffuse manner and has little applicability to others than producers, and even then the exemption is narrowly construed; *see, e.g.*, United States v. Frezzo Bros., Inc., 642 F.2d 59 (3d Cir. 1981), *remanded*, 546 F. Supp. 713 (E.D. Pa. 1982).

80. 33 U.S.C.A. §§ 407-409, 411 (West 1970).

81. 7 U.S.C.A. §§ 135-136y (West 1980); *see id.* at § 136j. Unlawful acts include distributing pesticides which are unregistered, adulterated, misbranded, unlabelled, or for which required records are not kept.

82. 15 U.S.C.A. §§ 2051-2083 (West 1982); *see id.* at § 2070.

83. 15 U.S.C.A. §§ 2601-2629 (West 1982); *see id.* at § 2602(2)(B)(ii) (West 1982).

84. Most statutes provide that "any person" in violation is subject to a penalty. This language has been held to inculpate corporate officials concurrently with a finding of criminal liability in the organization; *see, e.g.*, United States v. Wise, 370 U.S. 405 (1962); *see also* United States v. Corbin Farm Service, 444 F. Supp. 510 (E.D. Cal. 1978), *affirmed*, 578 F.2d 259 (9th Cir. 1978).

fully applicable to the many criminal statutes which provide that "any person" who violates the prohibition shall be liable.[85] Even so, several criminal statutes specifically provide (more by way of emphasis than necessity) that directors can be liable for violations.

First, liability for employment policies may occur in the areas of safety, hours, and wages. The principal statute concerning employment safety is the Occupational Safety and Health Act (OSHA).[86] This law is intended to provide a work place free from hazards, and violations of it are analogous to the public welfare offenses. Although there have been relatively few criminal prosecutions under OSHA, potential liability exists for agricultural cooperative directors because of the numerous hazards that can occur in the handling, processing, and distributing of agricultural commodities and inputs.[87] Directors who are aware of safety problems or OSHA violations must act to reduce or eliminate danger to employees. Otherwise, directors could be charged with a criminal offense under OSHA.

Similarly, wage and hour policies can also result in directors' criminal liability under the Fair Labor Standards Act.[88] This law is concerned with minimum wages, maximum hours, child labor, and related subjects. Its penalties are also applicable to "any person who willfully violates" the Act's provisions.[89]

The growing diversity of cooperative activities and business ventures can place directors in new areas of vulnerability respecting criminal liability. It would be impossible in an

85. This expansive reading of the range of persons liable for violations is consistent with the increase in personal accountability represented by such cases as United States v. Wise, 370 U.S. 405 (1962).

86. 29 U.S.C.A. §§ 651-678 (West 1975) (§ 666(e) provides for criminal liability for willful violations that cause the death of an employee).

87. 6 S. ARKIN, M. EISENSTEIN, E. DUDLEY, JR., D. RE, J. RAKOFF, J. SIFFERT, BUSINESS CRIME ¶ 29.01 (1983); *see, e.g.*, United States v. Pinkston-Hollar, Inc., D. Kan. No. 76-33-Cr 6, 4 BNA OSHC 1697 (1976) (where corporate officials were prosecuted under OSHA following an employee's death and the court, citing *United States v. Park*, stated that the responsible officials' position gave them power to prevent the violation, allowing them to be charged with criminal liability).

88. *See* 29 U.S.C.A. §§ 201-219 (West 1978).

89. 29 U.S.C.A. § 216 (West 1978).

article of this length to relate all the many specialized activities that have spawned agencies and regulations for their control.[90] Moreover, in addition to applicable federal laws, there are laws in every state to punish various acts of dishonesty such as fraud, embezzlement, and theft.[91]

As a result, where activities are regulated by federal or state agencies, the director must seek appropriate advice about the often particular requirements of action or avoidance to which he will be subject in the supervision of the cooperative. The simplest way directors can protect themselves from criminal liability for offenses involving dishonesty is by holding themselves to a high standard of integrity.

C. Securities Regulation

Agricultural cooperatives have a variety of financial arrangements with members and others for sources of equity capital. Some of these arrangements fall into the category of securities. In that event, directors of cooperatives may have special liabilities in connection with the issuance and transactions of the security.

At the present time, several of the common financial relationships between cooperatives and members (e.g., mem-

90. There are numerous other unlawful acts which are more obvious in their illegality and which a director must avoid. Many of these fall in the category of unlawful expenditures, such as unlawful campaign contributions, (The Federal Election Campaign Act) 2 U.S.C.A. §§ 431-455 (West Supp. 1977), payments to foreign officials (The Foreign Corrupt Practices Act) 15 U.S.C.A. §§ 78a, 78m(b), 78bd-1, 78dd-2, 78ff (West 1981), bribery of federal officials, 18 U.S.C.A. § 201 (West Supp. 1983), false statements (The False Statements Statute), 18 U.S.C.A. §§ 1001-1027 (West 1966), mail fraud, 18 U.S.C.A. § 1341 (West Supp. 1966-1982), or wire fraud, 18 U.S.C.A. § 1343 (West 1966), and the law prohibiting interstate transportation of goods gained by fraud, theft, or conversion, 18 U.S.C.A. § 2314 (West 1970).

91. Prohibited state acts include accepting kickbacks; *see, e.g.*, Dukehart-Hughes Tractor and Equipment Co. v. United States, 341 F.2d 613 (Ct. Cl. 1965) (explaining Iowa law on kickbacks); People v. Comstock, 147 Cal. App. 2d 287, 305 P.2d 228 (1956) (falsifying corporate records); Minich v. Gem State Developers, Inc., 99 Idaho 911, 591 P.2d 1078 (1979) (imposing liability for allowing a conveyance of encumbered realty with intent to defraud and the general offense of participating in unlawful business); National Life and Casualty Insurance Co. v. Hammel, 81 Nev. 125, 399 P.2d 446 (1965) (publishing false statements); Smith v. Galio, 95 N.M. 4, 617 P.2d 1325 (N.M. App. 1980) (preventing a shareholder's access to records); State v. Lunz, 86 Wis. 2d 695, 273 N.W.2d 767 (1979) (acquiescence in unlawful acts).

bership shares, patronage certificates) are not considered to be securities. However, some proposed schemes have failed to elicit assurance from the Securities and Exchange Commission (SEC) that it would not prosecute for failing to register the issue as a security. If the cooperative can arrange its financing to avoid entirely the issuing of securities, directors will be spared liability for securities violations.

Even if securities are issued, there may be exemptions from the requirement to register and liabilities associated with that requirement. Some agricultural cooperatives qualify for favorable tax treatment under Section 521 of the Internal Revenue Code.[92] Section 521 allows an exemption from registration under the Securities Act of 1933 so that transferable shares or other securities may be issued by exempt cooperatives without creating a risk of director liability for registration violations.[93] Some cooperatives may also be exempt from the provisions of the 1934 Securities Act which requires, among other things, registration for certain securities traded on a national exchange or in the over-the-counter market.

There are additional exemptions based on the manner in which the security is transacted. Exchanges, intrastate sales, and private or limited offerings may all be exempt from registration requirements. These exemptions are valuable since they may save the cooperative the expense of registration and may spare the director liability for registration violations.[94]

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92. Weiss, *Reasons for and Costs of Registration of Agricultural Cooperative Securities*, 3 AGRIC. L.J. 201, 207 (1981-82); *see also* U.S. Dep't of Agriculture, Farmer Cooperative Research Report, No. 17, March 1980; and *see* 26 U.S.C.A. § 521(b)(1) (West 1967).

93. 15 U.S.C.A. §§ 77a-77aa (West 1981); exemption given *id.* at § 77c(a)(5)(B) (West 1981). However, any post-issue trading necessitates registration and other requirements under the Securities Exchange Act of 1934, *see* 15 U.S.C.A. §§ 77b-78kk (West 1981), if the security is listed for trading on a national securities exchange (*id.* at § 78 1(b)) or is an equity security traded in the over-the-counter market and if the issuer has assets exceeding one million dollars held of record by 500 or more persons (*id.* at § 78 1(g), which allows at § 78 1(g)(2)(E) an exemption from registration for unlisted over-the-counter securities issued by a cooperative meeting the definition in the Agricultural Marketing Act of 1929, 12 U.S.C. 1141j(a) (1982)).

94. *See* N. HARL, 14 AGRICULTURAL LAW § 136.02[3] (1982). The usual cost of

In the event that the cooperative, the security, or the transaction are not exempt under the 1933 and 1934 Securities Acts, directors may be liable for securities violations in several areas, including the content or filing of registration statements and the purchase or sale of securities. Even if there is an exemption, directors can still be held liable for violations of the anti-fraud provisions of the Securities Acts.[95]

In addition to the liabilities possible under federal securities laws, the director must consider potential liability under state securities regulations. The states have constitutional and statutory freedom to adopt so-called blue sky laws concurrently with federal securities laws.[96] Each state has a blue sky law which may contain registration requirements and anti-fraud provisions. Many provide specific exemptions for agricultural cooperatives and their securities, but there is considerable diversity in these provisions.[97]

The avoidance of liability for violation of both federal and state laws regulating securities requires careful action on the part of the director. For directors of cooperatives who do not wish to be involved in securities activity, risk can be minimized by structuring a cooperative's financial arrangements to avoid the appearance of a security; abstaining from issuing obvious forms of securities; maintaining the cooperative's exempt status; limiting transactions to those types exempted from securities regulation; complying with anti-fraud provisions; and, if the cooperative is determined to engage in non-exempt securities activities, by preparing for the necessary expense, disclosure, and risk prevention under the guidance of an experienced securities lawyer.

D. Liability Associated with Records and Finances

There have been very few successful suits against direc-

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registering cooperative securities has been estimated at $100,000; *see* Weiss, *supra* note 92, at 211.

95. *See generally* W. KNEPPER, *supra* note 23, at chapters 10 and 11.

96. *See* Hall v. Geizer-Jones Co., 242 U.S. 539 (1917), and 15 U.S.C. § 77r (1981).

97. N. HARL, *supra* note 94, at § 136.03.

tors of cooperatives for liability in the area of records and finances. Most of the cases that have involved records and finances have been against the cooperative and not against the directors. Nevertheless, it is likely that there will be an increasing number of suits against directors of cooperatives in this area. It is a logical step to sue the directors, as decisionmakers, for damages resulting from financial dealings with a cooperative when the actions of the directors caused the financial injury.

1. False or Misleading Financial Statements

One of the most obvious sources of potential liability for corporate directors is the area of financial statements and reports. If an investor relies on a statement which later turns out to be false or misleading, or if the cooperative fails to file an annual report to the detriment of an investor or member, there are grounds for a suit. For their own protection, as well as to safeguard patron interests, directors should assure the completeness and accuracy of all financial statements and reports.[98]

2. Books and Records

Direct rulings by the courts on the general duty or necessity of keeping correct books and records, in the absence of any specific statutory requirement, are few in number.[99] In the general course of a corporation's business, however, it is necessary that proper books of account be kept. The director, by virtue of his position as a trustee with respect to stockholders, should therefore see that proper books of account are kept.

Requirements for keeping information about the financial structure and operations of cooperatives available are mentioned in a number of state statutes. A statement that adequate books must be kept for member use is found

98. L. GAROYAN and P. MOHAN, THE BOARD OF DIRECTORS OF COOPERATIVES 28 (1976).

99. FLETCHER, *supra* note 15, § 2187, at 625. The M.B.C.A. requires corporations to "keep correct and complete books and records of account." M.B.C.A. § 52 (1971).

in eighteen state statutes.[100] Nine state statutes require an audit of association books, presumably for accuracy and completeness.[101]

In one recent case, an unsecured creditor brought an action against a grain company and its corporate officers and directors for gross negligence in the performance of corporate duties (mismanagement of the business) in the wake of insolvency and the closing of the elevator. The auditor's report showed substantial mismanagement and improper use of funds, including personal use of corporate funds. The court said that the directors had breached their fiduciary duty owed to the corporation even though they had neither assumed active duties nor involved themselves in the day-to-day affairs or financial management of the corporation. Where directors have knowledge of mismanagement and misappropriation and fail to take steps to correct these acts, they breach their duty and are liable.[102] The court went on to say that at the least, a director's knowledge must amount to acquiescence.[103] It is important to note, however, that the duty to keep full and accurate accounts does not mean that directors must be able to render a bookkeeper's account of all receipts and disbursements.[104]

3. Reports

Most states require incorporated cooperative associations to make periodic reports to a state agency concerning the association's business affairs. Some state statutes require cooperatives to make the same annual reports required by other corporations. Others require cooperative marketing

100. J. BAARDA, U.S. DEP'T OF AGRICULTURE, STATE INCORPORATION STATUTES FOR FARMER COOPERATIVES 81 (Oct. 1982). Pennsylvania, for example, requires complete, appropriate, and accurate books and information on salaries and payments. PA. STAT. ANN. §§ 12013, 12118, 12167 (Purdon 1967). Texas requires standard accounting practices, statements, and information on capital and membership. TEX. REV. CIV. STAT. 1396-50.01 (35) (Vernon 1980).

101. J. BAARDA, *supra* note 100.

102. 229 Kan. 272, 276, 624 P.2d 952, 955 (1981).

103. *Id.* at 961. The court said further that the directors would be liable only to the corporation and stockholders or someone suing on their behalf.

104. *See supra* note 15, § 2188, at 627. The MODEL NON-PROFIT CORP. ACT § 25 also requires corporations to keep correct and complete books and records of account.

associations to make annual reports that may differ somewhat from annual reports made by other corporations.[105] An association that fails to file required annual reports may be subject to penalties. These penalties range from loss of good standing to involuntary dissolution of the association.[106]

Accordingly, directors of a cooperative have been held liable for failure to file annual reports and for filing false reports when their actions have caused injury. In one case, the court held that directors of the cooperative association were liable for debts to the plaintiffs because the directors failed to file an annual report and made a false report in violation of a state statute. The directors had delayed filing the report for three months after being elected. An annual report had not been filed in previous years. The report also contained false statements about the solvency of the cooperative.[107]

In a recent case, a cooperative's creditors sued, contending that individual directors were liable along with the cooperative on certain leasing agreements for which the cooperative was in default because of the failure to file a required annual report. Annual reports were, however, filed during the period in which the leasing agreements were made. The Supreme Court of Montana acknowledged the penal nature of the director's statutory liability for failing to file an annual report, and held that the directors were only liable for the debts of the cooperative incurred during the period of default in making and filing the annual report.[108]

Although a state statute may require the filing of an annual report with a state agency or official, it may not always

105. *See, e.g.*, ARK. STAT. ANN. § 64-1511(E) (Repl. 1980) and ARK. STAT. ANN. § 77-919 (Repl. 1981).

106. *See. e.g.*, N.C. GEN. STAT. § 10-15-36 (1976); S.D. COMP. LAWS ANN. §§ 47-18-15(1), 47-20-8 (1967) and 47-20-8.1 (1982); and COLO. REV. STAT. § 7-55-121 (1973). The consequences of failure to file may be the same as for other corporations.

107. Githers v. Clarke, 158 Pa. 616, 628 A. 232, 233 (1893). The court found the directors liable even though they were honest in their belief that the false statements about solvency were true.

108. Mountain States Supply v. Mountain States F. & L. Co., 149 Mont. 198, 201, 425 P.2d 75, 78 (1967). *See* Anderson v. Equity Co-op Ass'n of Roy, 67 Mont. 291, 215 P. 802 (1923).

be necessary to furnish the membership with annual reports. In one case, the court held that the directors of the cooperative were not guilty of fraud and mismanagement for failure to provide the members annual reports when the cooperative declined to furnish annual reports because of lack of membership interest.[109]

4. Inspection of Records

Directors may also be held liable if inspection of records is not permitted. Many state statutes require association books either to be open to inspection by members or to be distributed to members. A director may be held liable for failure to comply with this type of statute.[110] Courts will generally require that shareholders be allowed to examine corporate records once they make a showing of "good cause."[111]

5. Reliance on Records, Books and Reports

A number of states have adopted statutory provisions which allow directors to rely on the corporate books of account or upon financial statements of officers having supervision of the accounts. Good faith reliance is recognized as an absolute defense. The MBCA provides that in performing his duties a director may rely on information, opinions, reports, or statements prepared or presented by officers and employees, counsel, public accountants, committees of the board, and others, if they are, or if the director reasonably believes them to be, reliable and competent.[112] Some state cooperative statutes also recognize the reliance defense.[113] Even in the absence of statute, directors may, in the exercise of due care, ordinarily rely on the advice and report of of-

109. Golden v. St. Joseph Milk Producers Ass'n, 420 S.W.2d 31, 35 (Mo. Ct. App. 1967).

110. J. BAARDA, *supra* note 100. *See, e.g.*, N.M. STAT. ANN. § 53-4-33 (1978).

111. Elmore v. Superior Court, 255 C.A.2d 635, 63 Cal. Rptr. 307, 310 (Ct. App. 1967).

112. M.B.C.A. § 35, as amended July 1, 1981.

113. South Dakota, for example, protects cooperative directors who rely, in good faith, upon financial statements or accountant representations to make decisions. *see* S.D. COMP. LAWS ANN. §§ 47-17-7 (1967) and 47-17-7.1 (1982).

ficers, provided the directors exercise good business judgment concerning the accuracy of the reports furnished them and use care to inspect the reports.[114]

6. Accounting Procedures

Directors may also be liable if proper accounting procedures are not followed. Directors should see that an approved system of bookkeeping is adopted to protect against mistakes and false entries. This does not mean, however, that a director's duty of supervision requires him to proceed on the theory that officers' and employees' actions are under suspicion, that directors are required to examine the books themselves, or that an expert accountant must be employed to detect possible embezzlement. Therefore, absent a specific statute, until something happens which will put reasonably prudent directors on notice, directors are entitled to assume that officers, if selected with reasonable care, are honest and following an approved system.[115]

7. Tax Liability

Liability associated with records and finances may also arise in the tax sphere. There may be circumstances under which a corporation, or its officers, directors, and employees, will be held civilly or criminally responsible for errors, misstatements, and omissions (whether accidental or intentional) that occur in the corporate federal or state income tax return. It is clear that a corporation's directors, officers, and employees can be convicted of tax evasion while acting on behalf of the corporation.[116] In criminal tax cases, the prosecutor may decide to try the corporation alone, the responsible officers, directors, and employees alone, or join them all as defendants.[117]

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114. 12 W. FLETCHER, *supra* note 15, § 5435.1, at 111.

115. 3A W. FLETCHER, *supra* note 15, § 1076, at 99-100.

116. *See* Cromartie, *Civil and Criminal Sanctions Applicable to the Corporate Taxpayer, Its Officer, Directors, and Employees*, 55 TAXES 786, 786-87 (1977) [hereinafter cited as Cromartie] (*citing, e.g.*, United States v. Garber, 383 F.2d 448 (3d Cir. 1967); United States v. Lustig, 163 F.2d 85 (2d Cir. 1947)).

117. *Id.* at 788.

The Internal Revenue Code (IRC) and other federal statutes specifically set forth a series of substantive acts which, if violated in connection with the preparation and filing of corporate federal income tax returns, can result in the imposition of civil and criminal sanctions against corporations, their officers, directors, and employees. The IRC also spells out the rule that an officer or employee of a corporation can be punished for any tax crimes committed in connection with his official corporate duties.[118] Furthermore, there are civil fraud sanctions contained within the IRC.[119] Both the corporation and its officers may be liable for penalties because of violations of the fraud and negligence sanctions of the IRC. This follows from the fact that a corporation's fraud or negligence necessarily depends upon the acts and intent of its officers.[120]

8. Improper Distribution of Dividends

State statutes, or articles and bylaws of the cooperative, may limit the amount of dividends or interest payable on capital stock. Such limits may apply to common stock, preferred stock, or patronage-based equity. In addition, an alternative provision of the Capper-Volstead Act requires that an association not pay dividends on stock or membership capital in excess of 8 percent per annum.[121] Most states place a maximum limit on the amount of interest or dividends that may be paid on common or membership stock

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118. *Id.* *See* I.R.C. § 7343. The specific sections imposing liability include § 7201 (tax evasion), § 7203 (failure to file a return, supply information, or pay a tax), § 7206 (making or subscribing of false returns), and § 7207 (delivery or disclosing other fraudulent or false documents). Also, the U.S. Code imposes criminal sanctions for criminal activities in connection with the preparation and filing of a corporation's federal tax return. *See* 18 U.S.C. §§ 2, 287, 371, 1001 and 1621 (1976).

119. Cromartie, *supra* note 116, at 792. *See* I.R.C. § 6653 (b) (civil tax fraud, allowing a penalty for up to 50 percent of the total tax underpayment for the tax year of the civil fraud).

120. *See* negligence penalties in I.R.C. § 6653(a). Penalties may even be imposed on the corporation where the negligence or fraud was committed by an officer acting outside of his official duties. *See* The Crescent Mfg. Co., 7 T.C.M. (CCH) 630 (1948). *See also* I.R.C. §§ 6672, 6653 (e), and 6674 for further civil penalties which are included under the broad concept of personal liability.

121. *See* the Capper-Volstead Act, 42 Stat. 388 (1922), 7 U.S.C.A. § 291 (West 1980).

and preferred stock. A director may be liable for violating any of these limits.

Furthermore, changes in capital stock structure or modification of rights to dividends or interest may include changes in the amount of capital stock and changes in preferences for various classes of stock. Changes are normally brought about through an amendment to the articles of incorporation or bylaws. However, some state statutes specifically describe circumstances and voting requirements necessary for these types of changes and modifications. A director may also be held liable for violating any of these kinds of restrictions on changes and modifications in dividends.[122]

Cases have also arisen where shareholders have sought to require distributions by the board of directors. Although shareholders have generally sued only the cooperative association, directors could become targets for liability. In one case, a court said that failure to pay dividends and allow redemptive rights was an abuse of discretion since the charter and its bylaws required a revolving fund for the retirement of stock in those years when adequate capital had accumulated. The court held that the director's excuse of paying active members first was not valid, especially since the director's business with the cooperative comprised 80 percent of its total business.[123]

In another case,[124] preferred stockholders brought an action for an accounting and an order compelling the agricultural cooperative to comply with its articles of incorporation which required payment of dividends and the paying off of preferred stock. A dividend of 6 percent was to have preference over all other dividends and distributions, and preferred stock was to be retired when allocated reserves exceeded a specific amount. The cooperative paid patronage

122. J. BAARDA, *supra* note 100, at 109, 112-13. *See, e.g.*, 20A MINN. STAT. ANN. 308.07(1) (West 1969); N.M. STAT. ANN. § 53-4-7 (1978); and WIS. STAT. ANN. § 185.52 (West 1957). For M.B.C.A. codifications *see, e.g.*, NEB. REV. STAT. § 21-2046(1) (1981 Supp.) and S.D. COMP. LAWS ANN. § 47-5-15 (1967).

123. Driver v. Producers Cooperative, Inc., 233 Ark. 334, 345 S.W.2d 16, 19 (1961).

124. Collie v. Little River Coop., Inc., 236 Ark. 725, 370 S.W.2d 62 (1963).

refunds out of its net savings (profits) rather than building up the general reserve. Losses were also charged against the general reserve. Preferred stock dividends were never paid. Although the members of the board of directors of the cooperative were all common stockholders, the operation of the cooperative was built with investment capital (preferred stock). The court said the directors of the cooperative abused their discretion in failing to develop or maintain a rational balance between the amounts paid to the preferred stockholders and the active members, and in failing to provide, maintain, and build the allocated reserve required by the articles of incorporation.[125]

In particular, there are some questions that arise concerning whether shareholders can successfully maintain an action requiring the directors personally to pay the required dividends. There is, for instance, the question of whether an action can be brought by the stockholders in their individual capacity. One case concerning misfeasance (specifically, the misappropriation of corporate property) and the right to dividends indicates that if a shareholder of a cooperative tries to enforce his personal right to a declaration of dividends, the court can require a derivative action (a shareholder's suit to enforce the corporate claim) if misappropriation of corporate property is involved (for example, misappropriation can occur by paying patronage dividends rather than required preferred stock dividends, or by purchasing unnecessary assets rather than paying dividends). The court in this case noted that a suit to compel a declaration of dividends is a suit to vindicate primary and personal rights and is not the proper basis of a derivative suit.[126] Once restitution of corporate property is obtained by means of a derivative suit, proper dividend payments can be made. If the directors still refuse to declare dividends, an individual action can then be brought. Of course, an individual action can be brought ini-

125. *Id.* at 66. *See also* Hicks v. Polk County Farmers' Co-op, 51 Or. App. 21, 627 P.2d 890 (1981) (where redemption of "certificates of preferred interest," upon demand or within a reasonable time, was required when the cooperative was financially sound).

126. *See* Knapp v. Bankers Securities Corporation, 230 F.2d 717, 721 (3d Cir. 1956).

tially to compel payment of dividends for monies available that have not been misappropriated or misused (i.e. where the directors merely refuse to declare a dividend).

9. Depletion of Capital

Generally, a corporation may repurchase its own stock provided that its capital stock is not impaired. This general principle has also been applied to cooperatives.[127] Many states do, however, place limitations on common and preferred stock repurchased by cooperatives.[128] In addition, stock purchase plans or restrictions on stock repurchase may be made the subject of a legal action.

In suits seeking to defeat stock purchase plans, courts have upheld the purchase so long as there is no impairment of the corporation's capital stock or financial status. There is also the requirement that the purchase not diminish the corporation's ability to pay its debts or lessen the security of its creditors.[129]

In one case, a former member of a fishermen's cooperative sought to recover the value of his stock or membership interest in the cooperative and to have an accounting for patronage to which he was allegedly entitled.[130] The court held that an amended bylaw adopted by the cooperative, which altered the consideration to be received upon the redemption of shares from "fair book value" to original purchase price, was ineffective to divest the plaintiff of the right given him under the bylaw in effect when he purchased his stock. He was therefore entitled to receive, upon the termination of his membership, the fair book value of his shares. The court found that the amended bylaw infringed upon a vested right

127. Burk v. Coop. Finance Corp., 62 Wash. 2d 740, 384 P.2d 618, 623 (1963).

128. The most common statutory provision prohibits repurchase of common stock if the association's debts exceed 50 percent of its assets. J. BAARDA, *supra* note 100, at 117.

129. *But cf.* Rainford v. Rytting, 22 Utah 2d 252, 451 P.2d 769, 771 (1969); *see also* Whitney v. Farmers' Co-op Grain Co., 110 Neb. 157, 193 N.W. 103 (1923); Seagrave Corp. v. Mount, 212 F.2d 389 (6th Cir. 1954); *cf.* Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 391 P.2d 828 (1964), 38 Cal. Rptr. 348.

130. Lambert v. Fishermen's Dock Coop., Inc., 61 N.J. 596, 297 A.2d 566, 568 (1972).

of the plaintiff and exceeded the authority of the cooperative to amend the bylaws.[131]

Additionally, suits may arise over debt and losses sustained by the cooperative. Some states place credit limitations on cooperatives.[132] Wyoming makes directors liable to creditors if they consent to an excess of indebtedness over assets or subscribed stock. A director may be liable for payment of dividends or refunds if the association becomes insolvent, unless he has taken steps to file an objection to the board's actions causing the insolvency.[133]

For example, in one case a chemical company sold fertilizer to an agricultural cooperative.[134] After the cooperative became insolvent, the company sought to recover the unpaid portion of the purchase price from the directors of the cooperative on the ground that the directors had negligently permitted the indebtedness or liabilities of the cooperative to exceed the limits permitted in the bylaws and were therefore liable for the balance due. The court said the seller could not recover from the directors if the seller knew that the indebtedness limit had been exceeded. However, the court also said the burden was on the directors to prove that the seller knew the cooperative had exceeded its limits of indebtedness. In this instance, the court found the directors liable.[135]

Similarly, speculation which results in depletion of capital is a source of potential lawsuits against directors. Some courts, noting specific company authority to buy or sell commodities outside the state, have held speculative transactions to be legitimate (not *ultra vires* and not gambling or otherwise unlawful), and therefore actions against the directors of these companies were unsuccessful.[136] In contrast, when directors have used certain funds to speculate without authority, other courts have said that, although directors are

131. *Id.* at 571-72.

132. *See, e.g.*, IND. CODE ANN. § 15-7-1-11(m) (Burns supp. 1982).

133. WYO. STAT. ANN. §§ 17-10-114, 17-10-118 (1977).

134. Federal Chemical Co. v. Paddock, 264 Ky. 338, 94 S.W.2d 645 (Ky. App. 1936).

135. *Id.* at 648, 650-51.

136. *See* Clark v. Murphy, 142 Kan. 426, 49 P.2d 973, 975 (1935).

authorized to handle ordinary business affairs according to their best judgment, they are not excused by good faith from responsibility for speculative losses that were unauthorized and outside of the corporation's ordinary and usual scope of business.[137] Courts following this line of reasoning generally label speculative transactions as *ultra vires*, if not absolutely illegal. On the other hand, courts have upheld hedging practices of cooperatives as being neither *ultra vires* nor outside the purpose for which the corporation was created.[138]

As an illustration of the type of situations which can result in suits seeking to establish personal liability for directors' actions in speculative grain losses, consider the Farmers Export Company fiasco of the late 1970's and early 1980's.[139] Farmers Export's losses from speculative transactions in commodities during this period totaled about 35 million dollars, about one-half of the company's equity.[140] Although most of the speculative transactions involving losses by Farmers Export were undertaken by officers and employees, a good case probably could have been made that the directors knew or should have known about the transactions which were purportedly made to cover overhead. Of course, losses like these must be borne completely by the farmers owning stock in and patronizing the cooperative or by the member cooperatives, unless the farmers or their local cooperatives take action against someone such as the directors.

Finally, it should be noted that state statutes following the MBCA may impose liability on directors for the wrongful distribution of the assets of the cooperative upon liquidation, and for any loans made to any director or officer, unless

137. *See* Fagerberg v. Phoenix Flour Mills Co., *supra* note 33, at 1024-25 (three of the four corporate directors were held liable for wrongful conversion).

138. *See, e.g.*, South Carolina Cotton Growers' Coop. Ass'n v. Weil, 220 Ala. 568, 126 So. 637 (1929); and Fagerberg, *supra* note 33, at 1028-29.

139. *See A Farm Coop. in the Hands of High Rollers*, FORTUNE, Apr. 20, 1981, at 148-60.

140. *Id.* at 160. Apparently, speculation is not an uncommon occurrence among cooperatives. *See Will Your Co-op Lose Futures Gamble Next?*, FARMER COOPERATIVES, June 1982, at 21, which advocates a stated policy for managing price risk involving futures. One has to wonder, however, whether a stated policy will help if the cooperative is really speculating as opposed to hedging.

the loans are repaid in full.[141]

10. Patronage Refunds

Cooperative associations have traditionally relied on patronage refunds to return net margins or savings to patrons. Although use of patronage refunds is widespread, many state statutes do not describe them in any detail. However, certain statutory language may be taken as direct or indirect recognition of the patronage refund system and the requirement that net margins or savings be returned to patrons. For example, in addition to references made to the non-profit nature of the cooperatives, many statutes refer directly to the distribution of net margins or savings.[142]

The timing, level, and manner of payment of patronage equities is usually governed by the bylaws and is usually held to be a matter subject to the discretion of the board of directors. Nevertheless, equity redemption is often a lively issue. The dual demands of cooperative financing and member requests for redemption occasionally conflict.[143]

Although there have not been any cases holding directors personally liable for failure to pay patronage refunds or credits, there have been cases finding against the cooperative on the basis of abuse of director discretion. The courts more commonly side with the cooperative and its directors, and are hesitant to interfere in this aspect of a cooperative's business. Not surprisingly, some courts have distinguished pa-

141. *See, e.g.*, NEB. REV. STAT., § 21-2046(3) and (4) (Supp. 1982); and S.D. COMP. LAWS ANN. §§ 47-5-17 and 47-5-18 (1967). North Dakota, South Dakota, and Wisconsin makes directors jointly liable if they negligently or in bad faith vote a distribution of assets contrary to law or the articles of incorporation. *See* N.D. CENT. CODE § 10-15-31 (1976); S.D. COMP. LAWS ANN. § 47-17-7 (1967) and § 47-17-7.1 (Supp. 1982); and WIS. STAT. ANN. § 185.37(1) (1957).

142. J. BAARDA, *supra* note 100, at 96-97. *See, e.g.*, N.M. STAT. ANN. §§ 53-4-1, 53-4-31 (1978).

143. *See* Berde, *Overview of Legal Problems Affecting Cooperatives*, 2 AGRIC. L.J. 40, 47 (1980-81). For an excellent article on why a director must know member equity redemption rights, which also gives guidelines for staying within their discretionary authority, *see* S. Lurya, *Board of Directors Must Know Member Equity Redemption Rights*, FARMER COOPERATIVES, Aug. 1981, at 14-15. *See also* D. Smith, *Cooperatives Have Considerable Discretion Under Laws in Setting Redemption Policy*, FARMER COOPERATIVES, June 1981, at 4-5; and D. Cobia, *Equity Redemption: Issues and Alternatives*, FARMER COOPERATIVES, July 1980, at 18-21.

tronage ledger credits from debts, calling them capital investments.[144]

In the absence of bylaws, articles of incorporation, or statutes requiring payment, courts have usually held that boards of directors may in their reasonable discretion deny payment on demand to any member of the cooperative, even to the estates of deceased members, especially if expansion of operations would otherwise be seriously jeopardized, or where payment would cause undue financial hardship to the cooperative.[145] Courts have, however, recognized that a plaintiff-member may be able to show abuse of director discretion. Findings of abuse of discretion have been based upon proof of the cooperative's sound financial condition,[146] a lack of equality of treatment in repayment of capital credits,[147] and the fact that directors have a fiduciary obligation to members in regard to decisions affecting member capital.[148]

One court, siding with the plaintiff-member against the cooperative which had refused to make payment of deferred dividends, held that the directors had abused their discre-

144. Claussen v. Farmers Grain Coop., 208 Kan. 129, 490 P.2d 376, 379 (Kan. 1971).

145. *Id.* at 380. *See* Evanenko v. Farmers Union Elevator, 191 N.W.2d 258, 260 (N.D. 1971). *See also* Schmeckpepper v. Panhandle Coop. Ass'n, 180 Neb. 352, 143 N.W.2d 113 (1966). In this case the court noted that pursuant to statute, distributions (the rest of the earnings and savings after surplus is set aside) must be paid over to the patrons, but that they can be paid in cash, stock, equity credits, deferred credit certificates, or certificates of participation at the discretion of the board of directors. *Id.* 120. The court's decision was based on a statutory interpretation of when accumulated surplus must be paid. *Id.* at 117. *See also* Richardson v. South Ky. Rural Elec. Coop., 566 S.W.2d 779 (Ky. App. 1978). Likewise, even changes in the rights of outstanding shares may be valid if they can be justified as an exercise of fair business discretion in meeting the needs and exigencies of the corporate enterprise. *See* DeMello v. Dairyman's Coop. Creamery, 73 Cal. App. 2d 746, 167 P.2d 226, 228 (1946).

146. *See* Evanenko v. Farmers Union Elevator, 191 N.W.2d 258, 260-61. *See also* Lake Region Packing Ass'n Inc. v. Furze, 327 So. 2d 212, 215 (Fla. 1976) (where the Florida Supreme Court, relying on the business judgment rule, would not intervene to cause a distribution but left open the possibility of a challenge to board actions solely on the basis of economic considerations which, one might have thought, the business judgment rule would preclude the court from considering).

147. *In re* Great Plains Royalty Corp., 471 F.2d 1261, 1265 (8th Cir. 1973).

148. *See* Lake Region Packing Ass'n, Inc. v. Furze, 327 So.2d 212, 217 (Fla. 1976).

tion.[149] The directors had previously paid deferred dividends to other members in a like condition, and the cooperative was in a healthy financial condition. The directors could not show that payment of deferred dividends would create any undue hardship, and since the cooperative had received a benefit from the plaintiff's dividends, payment was required.[150]

Disagreements over setoffs may also give rise to suits involving directors. For example, the cooperative could bring an action against a member for goods sold or delivered. The member may then claim a setoff for accrued but unpaid patronage dividends or equity credits and may even demand the balance due. Questions then arise concerning whether the directors should have declared payments or made distributions, whether indebtedness is due and payable, and whether there has been an abuse of discretion. The cases have been divided as to whether such setoffs for patronage dividends are allowable.[151]

Another situation where questions involving patronage dividends may arise occurs when cooperatives merge. In one case involving an alleged merger the court said that, when agricultural cooperatives merge, dissatisfied members are entitled to revolving fund credits *at the discretion of the board of directors*.[152] But when there is no actual merger, but only a sale of assets followed by a dissolution of the "merged" cooperative (the one going out of existence), dissatisfied members of the "merged" cooperative are entitled to immediate payments of their revolving fund credits.[153]

149. Dyvig v. Farmers Coop. Ass'n, Civil No. 13730, (Iowa Dist. Ct., Humboldt, Co. 1973); *cf.* First Nat'l Bank v. Baron County Coop. Dairy, 252 N.W.2d 57, (Wis. 1977).

150. First Nat'l Bank v. Baron County Coop. Dairy, 252 N.W.2d at 59-60.

151. *See* Southeastern Colo. Coop. v. Ebright, 38 Colo. 326, 563 P.2d 30, (Ct. App. 1977) (allowing a setoff); *contra* Clarke County Coop. v. Read, 243 Miss. 879, 139 So. 2d 639 (1962); and Forrest County Coop. Ass'n v. Manis, 235 So. 2d 925 (Miss. 1970) (denying setoff).

152. Weise v. Land O'Lakes Creameries, Inc., 191 N.W.2d 619, 622 (Iowa 1971).

153. *Id.* at 623.

11. Other Actions of Directors

In a variety of other circumstances relating to records and finances, directors of cooperative associations may be held liable for their actions. Directors may be sued for breaches or defaults in the cooperative's marketing agreements which were caused because the cooperative made insufficient payments. These defaults may constitute mismanagement of the cooperative's affairs. However, if directors make good faith errors of judgment in marketing-sales transactions, liability is normally not placed upon them or the cooperative.[154]

Directors have been held liable for misapplication of corporate funds when they acted without reasonable care to preserve, conserve, and protect the assets of the corporation by permitting another officer to direct the corporation.[155] Conversely, directors of a farmers' grain cooperative were held not liable for an alleged willful conversion of grain belonging to a farmer when his oats were sold and no remittance made to him.[156] In that case, the court said there was nothing to indicate that the directors did not exercise care and prudence in selection of the manager (who arranged the wrongful transactions). The directors neither assumed general supervision of the conduct of the business nor did they know of or acquiesce in the wrongful conduct of the manager.[157]

Finally, many state "conflict of interest" statutes prohibit a director from becoming a party to a contract for profit with the association which differs in any way from business relations accorded regular members, holders of common stock, or others, or which differs from generally prevalent terms.[158] Nevertheless, in spite of a conflict of in-

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154. *See* Nebraska Wheat Growers' Ass'n v. Smith, 115 Neb. 177, 212 N.W. 39, 44-45 (1927).

155. *See* Dome Realty Co. v. Rottenberg, 285 Mass. 324, 189 N.E. 70 (1934).

156. *See* Lowell Hoit & Co. v. Detig, 50 N.E.2d 602, 603-04 (Ill. App. Ct. 1943). The court added that directors are treated more favorably in regard to a single isolated incident of fraud than they will be in cases of open and habitual improper practices easily detected by the directors.

157. *Id.*

158. J. BAARDA, *supra* note 100, at 89; *see, e.g.*, ALASKA STAT. § 10.15.180

terest statute, one court upheld the right of a cooperative to emply a director as a business manager for fair remuneration.[159] On the other hand, in a derivative action against the cooperative and its directors and former directors, another court found that failure of the board of directors to investigate two employees' conflicts of interest, after having actual knowledge that they were faithless employees, was *prima facie* gross negligence and culpable mismanagement for which the directors were liable.[160]

There have been few cases holding directors personally liable for authorization of false or misleading financial statements and reports, improper distribution of dividends, depletion of capital, improper payment of or denial of payment of patronage dividends, failure to give annual reports, or authorization of other actions involving misappropriation or misuse of cooperative property or funds. Nevertheless, directors should be aware of this type of potential liability and should act with due care.

E. Antitrust Regulation

It is important for directors of cooperatives to be aware of provisions dealing with monopolization and restraint of trade because agricultural cooperatives are not completely immune from antitrust prosecution and civil proceedings, although certain exemptions are granted in the Capper-Volstead Act, other federal statutes, and state antitrust statutes. The application of antitrust law to agricultural cooperatives is uncertain, especially in relation to the personal criminal and civil liability of directors. Moreover, antitrust law is one

(2)(1982); KY. REV. STAT. § 272.171(5) (1981); 4 N.J. STAT. ANN. § 4:13-19 (1973); OR. REV. STAT. § 62.300(2)(1981); and Wash. Rev. Code Ann. §§ 24.32.110, 24.32.320 (1969).

159. Oliver v. Halstead, 86 S.E.2d 858 (Va. 1955); *see* Kennerson v. Burbank Amusement Co., 260 P.2d 823 (Cal. App. 1953); and Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. App. 1952). *See also* Corr v. Leisey, 138 So. 2d 795, 800 (Fla. 1962) (where the court found that the contract between the director and the defendant, a third party disinterested purchaser, was enforceable where a full disclosure of the director's proposed acquired interest had been made to the other directors before the sale).

160. Parish v. Maryland & Virginia Milk Producers Ass'n, 250 Md. 24, 242 A.2d 512, 452 (1968).

area where corporate law diverges considerably from cooperative law because of the specific exemptions from antitrust laws which apply to cooperatives. Still, many principles of antitrust law apply equally to cooperatives as well as to other corporations.

1. Applicable Corporate Antitrust Principles

The antitrust laws were enacted by Congress to protect the public from business combinations that tended to monopolize and restrain interstate trade. To implement this purpose, the laws established a procedure whereby the federal government could investigate suspected violations and institute both criminal and civil proceedings. Compliance was insured by Congressional approval of private enforcement. Section 4 of the Clayton Act[161] gives to anyone injured in his "business or property," by reason of an antitrust violation of any kind, an action for treble damages.[162]

Section 4 of the Clayton Act does not restrict the private litigant's right to name individuals as defendants in treble damage suits. Questions may therefore arise concerning directors' liability under the treble damage provision. Although private antitrust suits are numerous, there are relatively few cases in which corporate officers and directors are named defendants. This is understandable when one considers the greater likelihood of a corporation being able to satisfy a large treble damage judgment. However, some plaintiffs do sue the executive and the corporation as joint tortfeasors. Additionally, where the corporation is insolvent, a plaintiff may decide to sue the director alone.[163]

An action by a private individual seeking treble damages is an action based on personal liability, in tort, for the damages actually sustained to "business or property." The leading case applying the agency rule of liability for treble damages to a corporate executive is *Kentucky-Tennessee*

161. 15 U.S.C.A. § 15 (West Supp. 1983).

162. Note, *The Anti-Trust Laws and the Corporate Executive's Civil Damage Liability*, 18 VAND. L. REV. 1938, 1939 (1965).

163. *Id.*

Light & Power Co. v. Nashville Coal Co.[164] In this action, the court held that if participation in the unlawful antitrust transaction was proven, the executive would not be relieved of liability merely because he was an agent of the corporation making the illegal payment; he must personally suffer the consequences of his own tortious conduct.[165]

Under the antitrust laws, offending parties are presumed to have intended the natural consequences of their conduct, and specific intent to restrain trade, eliminate a competitor, or create a monopoly is not necessary in order to be found guilty of an antitrust violation. Therefore, a director cannot escape liability on the grounds that he acted with good intentions or that he honestly did not believe he was violating the law.[166]

In addition, even where the executive is not charged with having actively participated in the prohibited conduct, liability may result from passive acquiescence or ratification of illegal activities. To prove acquiescence, it must be shown that the executive had knowledge of and approved of the activities and their unlawful objective. Actual knowledge is not the sole requirement. If the executive has been put on notice that unlawful activities are being conducted, he cannot close his eyes to it. He is, in fact, charged with knowledge of all that a reasonable inquiry would have revealed.[167]

A second legal theory imposing civil treble damage liability upon directors is based on the corporation's criminal liability. Section 14 of the Clayton Act,[168] the so-called personal guilt provision, provides that whenever a corporation violates any of the penal provisions of the antitrust laws, the violations will also be applied to those of its individual di-

164. 37 F. Supp. 728 (W.D. Ky. 1941), *aff'd sub nom*, Fitch v. Kentucky-Tennessee Light & Power Co., 136 F.2d 12 (6th Cir. 1943).

165. *Id.* at 732.

166. Note, *supra* note 162, at 1941-43. *See* United States v. Griffith, 334 U.S. 100, 105 (1948); *see also* Sunkist Growers, Inc. v. Winckler & Smith Citrus Prods. Co., 284 F.2d 1, 26 (9th Cir. 1960), *rev'd*, 370 U.S. 19 (1962).

167. Note, *supra* note 162, at 1943.

168. 15 U.S.C. § 24 (1976). A violation is a misdemeanor which is punishable, upon conviction, by a fine not exceeding $5,000, or by imprisonment for a period not exceeding one year, or by both.

rectors, officers, or agents who authorized, ordered, or did any of the illegal acts. However, the Supreme Court of the United States has never held the finding of corporate liability sufficient, without more, to extend liability to corporate agents who were completely unaware of any wrong-doing.

The Supreme Court has held that Section 14 of the Clayton Act does not provide an exclusive remedy for violations of Section 1 of the Sherman Act,[169] and therefore does not preclude prosecution of corporate personnel under the Sherman Act.[170] Most of the litigation in antitrust centers around the Sherman Act. Thus, any corporate executive who knowingly participates in an illegal contract, combination, or conspiracy may also be subject to prosecution under the much more stringent criminal penalties provided by the Sherman Act, regardless of whether he authorizes, orders, or helps perpetrate the crime, or whether he acts in a representative capacity.[171]

Furthermore, Sections 1 and 2 of the Sherman Act refer to offenses committed by any "person" or "persons." These provisions apply to "every person engaged in business whose activities might restrain or monopolize commercial intercourse among the states."[172] Liability under the Sherman Act has been extended to all persons who knowingly participate in a violation of its provisions or who aid or abet another in the commission of an offense. The Supreme Court has included individual corporate officers and directors within the definition of "persons,"[173] since a corporation can

169. 15 U.S.C. §§ 1-7 (1976).

170. *See* United States v. Wise, 370 U.S. 405, 414 (1962).

171. 16B J. VON KALINOWSKI, BUSINESS ORGANIZATIONS § 11.13, at 11.86-11.87 (1969); *see also* 16L V. KALINOWSKI, BUSINESS ORGANIZATIONS § 98.02[2], at 98.9-98.10 (1969). For violations of §§ 1, 2, or 3 of the Sherman Act, the corporate officer or director may be punished by a fine not exceeding $100,000. 16B J. VON KALINOWSKI, *supra*, at 11.87 n.6; 15 U.S.C. §§ 1-3 (1976). The corporation is now subject to a fine of up to $1,000,000 and an individual defendant may be convicted of a felony and be imprisoned for up to three years, as well as being fined. Moreover, Section 14 of the Clayton Act probably does not preclude an individual officer or director from criminal prosecution under Sections 2 and 3 of the Sherman Act. 16B J. VON KALINOWSKI, *supra*, at 11.87.

172. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 553 (1944), *reh'g denied*, 323 U.S. 811 (1944).

173. *See* United States v. Wise, 370 U.S. 405 (1962).

act only through its officers and directors.

Even so, an individual director cannot be charged with conspiring with his corporation to restrain trade or to monopolize or attempt to monopolize trade in violation of Sections 1 and 2 of the Sherman Act.[174] Most courts have taken the view that a conspiracy requires at least two persons or entities, and that there is only one entity (the corporation), at least where the executive acts for the corporation in the ordinary scope of his duties.[175] Where the executive acts in other than a purely official capacity, however, he is regarded by the law as an entity separate from the corporation so that there may be a conspiracy in violation of either Section 1 or Section 2 of the Sherman Act.[176]

It is also well recognized that there can be a conspiracy, in violation of the Sherman Act, between a parent corporation and its subsidiaries, or between two or more subsidiaries, where the purpose and effect of the concerted action involved is to restrain the trade of outsider entities.[177] Presumably, there can also be a conspiracy between the executives of the corporation and the executives of the subsidiary or between the executives of one entity and another corporate entity.

A distinction can be made between Sections 1 and 2 in this regard because Section 1 does not make a restraint of trade, standing by itself, a substantive offense. Since a corporation is incapable of violating Section 1 by itself, it follows as a matter of logic that concerted action between members of the same corporate family does not constitute a conspiracy within the meaning of Section 1. However, in Section 2, under the rationale recognized by some authorities, if the corporation itself can violate the antitrust laws, its officers and directors or its subsidiary corporations can conspire to commit a Section 2 offense (by devising a scheme to

174. Shoenberg Farms Inc. v. Denver Milk Producers, Inc., 231 F. Supp. 266, 269-70 (D. Colo. 1964); and Cott Beverage Corp. v. Canada Dry Ginger Ale, Inc., 146 F. Supp. 300, 301 (S.D.N.Y. 1956), *appeal dismissed*, 243 F.2d 795 (2d Cir. 1957).

175. *Cf.* Marion County Coop. Ass'n v. Carnation Co., 114 F. Supp. 58, 62-63 (W.D. Ark. 1953), *aff'd*, 214 F.2d 557 (8th Cir. 1954).

176. 16B J. VON KALINOWSKI, *supra* note 171, § 7.02[1], at 7-26.

177. *Id.* at 7-27 n.16.

achieve a monopoly).[178]

The matter of whether or not a cooperative and its subsidiaries, and therefore its directors, officers, and employees, can conspire to violate the antitrust laws has been a subject of frequent litigation. Most cases have only considered the threshold question of whether the organizations themselves have conspired to violate the antitrust laws, and not the question of whether the directors are individually liable for conspiracy.[179] But, by analogy, it can be argued that the Capper-Volstead exemption to the antitrust laws will not protect combinations of producer and non-producer interests, and that therefore directors involved in the conspiracy may be held liable for Sherman Act violations.

Additionally, Section 2(a) of the Clayton Act, as amended by Section 1 of the Robinson-Patman Act, specifically prohibits "any person" from engaging in certain discriminatory pricing practices.[180] Courts have uniformly held that an officer, director, or employee of a corporation may be sued in his individual capacity for acts done on behalf of the corporation if those acts violate the Robinson-Patman Act. Corporate personnel have been held liable under this section for any unlawful or improper act in which they knowingly

178. 16B J. VON KALINOWSKI, *supra* note 171, § 9.02[2], at 9-34.

179. *See also* Sunkist Growers, Inc. v. Winckler & Smith Citrus Products Co., 370 U.S. 19 (1962) (where the Supreme Court held that a marketing cooperative, a subsidiary processing cooperative, and a separate processing organization comprised of cooperative member associations were not independent parties, and were therefore immune from the conspiracy provisions of Sections 1 and 2 of the Sherman Act, even though they were formed into three separate legal entities); Broiler Marketing Ass'n. v. United States, 436 U.S. 816 (1978) (where the Court held that if not all the persons engaged in the production of an agricultural product are farmers (even if only one is not), cooperative producer associations are not sheltered from Section 1 of the Sherman Act by Capper-Volstead exemptions); Green v. Associated Milk Producers, Inc., 692 F.2d 1153 (8th Cir. 1982); *In re* Midwest Milk Monopolization Litigation, 510 F. Supp. 381 (W.D. Mo. 1981); *but see* Case-Swayne Co., Inc. v. Sunkist Growers, Inc., 389 U.S. 384, 395-96 (1967), *reh'g denied*, 390 U.S. 930 (1968) (where non-producer interests which are agency associations (private corporations and partnerships which handle cooperative products)) were found in conspiracy and combination in violation of Section 1 and not entitled to the Capper-Volstead defense).

180. 38 Stat. 730 (1914) (current version at 15 U.S.C. § 18 (1976)) (as amended by § 1 of the Robinson-Patman Act, 15 U.S.C. § 13(a) (1976)).

participated.[181]

Section 3 of the Robinson-Patman Act makes it a crime to sell goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor. Sales made below cost without any legitimate commercial objective and with specific intent to destroy competition violate the antitrust laws because of Section 3.[182] Section 4 of the Act provides a limited exemption for cooperative associations by allowing them to return to their members all or any part of the net earnings or surplus resulting from the cooperative's trading operations.[183] Section 4 applies only to the payment of earnings to members, however, and does not provide cooperative associations with a blanket exemption from the prohibitions of Robinson-Patman or of the antitrust laws generally.[184]

2. The Derivative Suit—Personal Liability for Antitrust Violation Because of Breach of Fiduciary Duty to the Corporation

The corporate executive stands in a fiduciary relation to the shareholders of the corporation. Thus, the executive owes the shareholders and the corporation he serves a duty to use reasonable care in the performance of his management functions. To violate the antitrust laws in the performance of his duties is not an exercise of reasonable care on his part. Violating the antitrust laws may therefore render the director liable to the corporation for damages caused by his unlawful conduct. This liability extends to fines, treble damages, and litigation expenses. If the corporation wrongfully refuses to enforce its cause of action against the executive, one or more of the shareholders may bring a derivative suit against the guilty executive and seek recovery on behalf of the corporation.[185]

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181. 16C J. VON KALINOWSKI, BUSINESS ORGANIZATIONS, *supra* note 171, § 24.02 [2] & [3], at 24-4 to 24-6.

182. United States v. Nat'l Dairy Products Corp., 372 U.S. 29, 33 (1962). *See* 15 U.S.C. § 13(a), *supra* note 180.

183. *See* 15 U.S.C. § 13(b), *supra* note 180.

184. 16D J. VON KALINOWSKI, *supra* note 171, § 36.03 [3], at 36-49 to 36-50.

185. Note, *supra* note 162, at 1950. A shareholder's derivative suit against a cor-

To maintain a derivative suit, the shareholder must allege and prove that the executive has breached his fiduciary duty to the corporation and to the shareholders. Secondly, the shareholder must prove that the executive knew, or with the exercise of reasonable care should have known, that he was violating the antitrust laws or was causing the corporation to do so.[186] The third element to be proved in a derivative suit is that the corporation has suffered an injury because of the unlawful conduct of the executive. There must be proof of an independent nature establishing the injury. The damages recovered against the director in a derivative action are single damages, not the treble damages awarded under Section 4 of the Clayton Act.[187]

3. Criminal Antitrust Enforcement

The Antitrust Division of the Department of Justice and the Federal Trade Commission have the primary authority to enforce the antitrust laws. The Antitrust Division has authority for the enforcement of the Sherman Act, the Clayton Act, and the Robinson-Patman Act. Jurisdiction is shared with the Federal Trade Commission with respect to the Clayton and Robinson-Patman Acts.[188] The Federal Trade Commission also enforces Section 5 of the Federal Trade Commission Act,[189] which declares unfair methods of competition and unfair or deceptive acts or practices in, or affecting, commerce to be unlawful. However, the Federal Trade Commission Act is not classified as an antitrust act. Although it is designed to protect the public interest, there is no authority for the Federal Trade Commission to act solely in the interests of individuals who have been exposed to unlawful practices. Even so, violations of the Sherman or Clayton

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porate executive for breach of fiduciary duty by violating the federal antitrust laws is a suit under state law rather than federal law. The state courts are competent to determine alleged breaches of fiduciary duty and to determine if the alleged conduct was in violation of the federal law. *Id.* at 1951-52.

186. *Id.* at 1953-54. Whether the director's conduct was in furtherance of the corporation's interest should not be a consideration for the courts.

187. *Id.* at 1956-58.

188. 16L J. VON KALINOWSKI, *supra* note 171, § 98.01, at 98-2 n.1.

189. See 38 Stat. 719 (1914) (as amended, 15 U.S.C. § 45 (1983)).

Acts may also be violations of the Federal Trade Commission Act.[190]

Whether a criminal or civil action will be brought by the Antitrust Division depends, in part, on the type of conduct involved. It is a rule of the Antitrust Division that criminal prosecution will be initiated where willful violations of the law are involved (willfulness may be established by actions constituting *per se* offenses or by intentional violations). Not all antitrust statutes are criminal in nature, however. Criminal actions may be brought under Sections 1-3 of the Sherman Act, Section 14 of the Clayton Act, and Section 3 of the Robinson-Patman Act. But even if the Antitrust Division does not initiate criminal prosecution, it is not precluded from filing a civil action based upon the same alleged violation. Indeed, it is agency policy to do so.[191]

4. Exemptions from the Antitrust Laws—Capper-Volstead Act and Section 6 of the Clayton Act

The general antitrust principles can only be understood in light of the immunity that agricultural cooperatives have from the antitrust laws under Section 6 of the Clayton Act and the Capper-Volstead Act.[192] Section 6 of the Clayton Act specifically permits farmers to act together in cooperative associations not having capital stock.[193] The Capper-Volstead Act extends the exemption from the antitrust laws to agricultural producers in associations, with or without

190. 16E J. VON KALINOWSKI, *supra* note 171, § 39.05 [1], at 339-27-39-28. *See id.* § 39.04 [5], at 39-19, *citing* Atlanta Buick Co. v. O'Neal, 44 F. Supp. 39 (E.D. Tex. 1942) (which held that a private party action for treble damages, available under Section 4 of the Clayton Act, cannot be brought for a violation of Section 5 of the Federal Trade Commission Act because the after is not classified as an antitrust act). *See also* 15 U.S.C. § 45(l) and (m) (1983), *supra* note 189 (for civil penalties).

191. 16L J. VON KALINOWSKI, *supra* note 171, § 98.01 at 98-2 to 98-4.

192. 38 Stat. 731 (1914), 15 U.S.C. § 17 (1973); and 42 Stat. 388 (1922), 7 U.S.C. §§ 291-292 (1980), respectively. The Fishermen's Collective Marketing Act of 1934 gave fishermen and planters of aquatic products the same rights to form marketing cooperatives that the Capper-Volstead Act gave to farmers. *See* 48 Stat. 1213-1214 (1934), 15 U.S.C. §§ 521-522 (1976).

193. *See* Maryland & Virginia Milk Producers Ass'n v. United States, 362 U.S. 458 (1960).

capital stock, when they are acting together to collectively handle, market, and process agricultural products. It also allows associations to operate marketing agencies in common. However, the protections of the Capper-Volstead Act extend only to those associations that meet its specific requirements.[194] It should be noted also that supply cooperatives are subject to the same antitrust laws and regulations as other business corporations.[195] In effect, cooperative associations are exempt from liability for such things as collective marketing of farm products,[196] banding together for purposes of contract negotiations (collective bargaining),[197] and setting pricing policies (collective price-fixing).[198]

Cooperatives may also combine to do what they may do individually. They cannot be conspirators to the extent that their concerted action is in pursuit of legitimate aims.[199] Similarly, cooperatives may, singly or in combination with other exempt cooperatives, obtain monopoly power in a given market so long as that power is achieved through natural growth or voluntary confederation and not by predatory or anti-competitive practices.[200]

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194. *See* 7 U.S.C. § 291 (1976). That section states the requirements an association must meet in order to qualify for the Capper-Volstead exemption from the antitrust laws — that the association be operated for the mutual benefit of members, that the association not deal in products of non-members in an amount greater in value than it handles for members, and that the association conform to one or both of the following requirements: that no member of the association have more than one vote, and that the association not pay dividends on stock or membership capital in excess of eight percent per annum.

195. L. GAROYAN and P. MOHAN, *supra* note 98, at 28.

196. *See supra* note 193, at 466.

197. Treasure Valley Potato Bargaining Ass'n v. Ore-Ida Foods, Inc., 497 F.2d 203, 215 (9th Cir. 1974).

198. *See* Fairdale Farms, Inc. v. Yankee Milk, Inc., 635 F.2d 1037 (2d Cir. 1980); Kinnett Dairies, Inc. v. Dairymen, Inc., 512 F. Supp. 608 (M.D. Ga. 1981); Northern Cal. Supermarkets, Inc. v. Central Cal. Lettuce Producers Coop., 413 F. Supp. 984, 993 (N.D. Cal. 1976); and Waters v. Nat'l Farmers Org., Inc., 328 F. Supp. 1229 (S.D. Ind. 1971) (which included collective bargaining within the exemptions from the antitrust laws under the Capper-Volstead Act).

199. Sunkist Growers, Inc. v. Winckler & Smith Citrus Prods. Co., 370 U.S. 19, 27 (1962).

200. Fairdale Farms, Inc. v. Yankee Milk, Inc., 635 F.2d 1037, 1044 (2d Cir. 1980). Farmers should be able to associate in any number without regard to the extent of the resulting market dominance, free from the charge of unlawful monopoliza-

It is, however, clear that only agricultural associations are within the scope of the Capper-Volstead exemption. No middlemen may infiltrate otherwise exempt cooperatives, and vertical integration of agricultural industries may not extend to a point where non-farmer middlemen can claim the Capper-Volstead shield.[201]

Cooperatives have occasionally sought to extend their market power in ways not intended by Congress. In *Maryland & Virginia Milk Producers Ass'n. v. United States*,[202] the Supreme Court summarized a number of "anti-competitive activities which are so far outside the 'legitimate objects' of a cooperative that, if proved, they would constitute clear violations of Section 2 of the Sherman Act."[203] Included among the prohibited activities were a cooperative's attempt to interfere with truck shipments of non-members' milk, boycotts to compel purchase of products, and the use of a prior debt to influence a dairy to buy only from the cooperative. Also, the court held that "even lawful contracts and business activities may help to make up a pattern of conduct unlawful under the Sherman Act."[204]

Other courts have also held that an anti-competitive practice may not be justified by economic considerations where the practice is undertaken with an unlawful intent and in the desire to achieve an unlawful goal.[205] Where an unlawful intent is clear, overt acts in furtherance of this purpose are not immunized simply because they might also have other justifications or because they are merely "anti-competitive" rather than "predatory."[206]

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tion under § 2 of the Sherman Act. *See, e.g.*, Cape Cod Food Prod., Inc. v. Nat'l Cranberry Ass'n, 119 F. Supp. 900, 907 (D. Mass. 1954).

201. *See* Nat'l Broiler Mktg. Ass'n v. United States, 436 U.S. 816, 827-829 (1978); and Case-Swayne Co., Inc. v. Sunkist Growers, Inc., 389 U.S. 384, *reh'g denied*, 390 U.S. 930 (1968). However, in a recent case, the "not even one" non-farmer member requirement of the *Nat'l Broiler Mktg.* case was held not to apply to the ignorance or sloppiness of some cooperative membership rolls; *see* Alexander v. Nat'l Farmers Org., 687 F.2d 1173, 1185-87 (8th Cir. 1982).

202. 362 U.S. at 458 (1960).

203. *Id.* at 468.

204. *Id.* at 472.

205. United States v. Dairymen, Inc., 660 F.2d 192, 195 (6th Cir. 1981).

206. 687 F.2d at 1183.

These limited immunity principles must also be harmonized with the ordinary intent element of Section 2 of the Sherman Act. Attempted monopolization and conspiracy to monopolize usually require a showing of specific intent to monopolize, but a cooperative may lawfully form this intent. It is impermissible to pursue this monopoly power through predatory or anti-competitive practices. Of course, a conspiracy or combination to eliminate competition through unlawful means would also violate Section 1 as an unreasonable restraint of trade.[207]

In *Alexander v. National Farmers Organization*[208] the Eighth Circuit Court of Appeals found a conspiracy involving concerted use of predatory and other unlawful tactics. Section 2 of the Sherman Act was violated to the extent that the cooperative's aim was to unlawfully acquire monopoly power, and Section 1 was violated to the extent that the cooperative's aim was to unlawfully eliminate the competition. However, the court said Sections 1, 2, and 3 of the Sherman Act "closely overlap and the same predatory practices may show violations of all."[209] The unlawful predatory tactics used in this case included discriminatory pricing, coercive supply disruptions and threats of similar conduct, as well as bad faith harassment and threats of litigation. Also, additional incidents including discriminatory membership and hauler terminations, certain milk pooling practices, and acquisitions and mergers, which would have been lawful standing alone or in some other context, were held to be evidence of the unlawful conspiracy because they were unlawfully aimed at eliminating a competitor.[210]

Over the years the courts have specifically identified the types of practices which cooperatives cannot use to acquire monopoly power. These practices have been identified as either predatory practices or practices which unreasonably

207. *Id.*; *see also* Maryland & Virginia Milk Producers Ass'n v. United States, 362 U.S. 458, 463, 468-72 (1960).

208. 687 F.2d 1173 (8th Cir. 1982). Another cooperative was the specific target of the conspiracy.

209. *Id.* at 1191-92, citing Maryland and Virginia Milk Producers Ass'n v. United States, 362 U.S. 458, 463 (1960).

210. Alexander v. Nat'l Farmers Org., 687 F.2d 1173, 1193, 1204 (8th Cir. 1982).

restrict trade. In brief, specific practices identified have included: (1) knowingly making or permitting a false financial report about competitors; (2) price fixing with non-cooperatives; (3) coercion or intimidation of a competitor's members to cause them to breach or terminate the competitor's marketing agreements;[211] (4) conspiracy to fix prices by use of rebates to processors solely for the purpose of inducing purchase of the cooperative's product over products of others; (5) shipping the cooperative's product out of state and then reshipping it back into the state to avoid a state's regulatory pricing; (6) boycott or threatened boycott of processors in order to stop them from purchasing from non-cooperative producers;[212] (7) coercing persons to join the cooperative;[213] (8) group boycotts or other illegal boycotts;[214] (9) picketing or other predatory harassment;[215] (10) unreasonably preventing termination of producer membership in marketing agreements; (11) unreasonably restricting independent haulers' rights through the use of exclusive hauling contracts; (12) discriminatory restrictions on purchasers because of business relationships with competitors;[216] and (13) pooling practices carried out with a predatory intent to

211. *In re* Midwest Milk Monopolization Litig., 510 F. Supp. 381 (W.D. Mo. 1981); *See* Green v. Associated Milk Producers, Inc., 692 F.2d 1153 (8th Cir. 1982).

212. Knuth v. Erie Crawford Dairy Coop. Ass'n, 395 F.2d 420, 423-25 (3d Cir. 1968).

213. Fairdale Farms Inc. v. Yankee Milk, Inc., 635 F.2d 1037 (2d Cir. 1980); and Gulf Coast Shrimpers and Oysterman's Ass'n v. United States, 236 F.2d 658, 665 (5th Cir. 1956).

214. Fairdale Farms, Inc., v. Yankee Milk, Inc., 635 F.2d 1037 (2d Cir. 1980); North Texas Producers Ass'n v. Metzger Dairies, Inc., 348 F.2d 189, 196 (5th Cir. 1965); *see* Boise Cascade Int'l., Inc. v. Northern Minn. Pulpwood Producers Ass'n, 294 F. Supp. 1015 (D. Minn. 1968), where a loosely organized association of pulpwood producers was found to be an agricultural organization but could not continue a boycott in violation of existing contracts because the boycott included some who were not members and the association did not represent them. Hence, the association had stepped outside the scope and purpose of the Capper-Volstead Act exemption. Group boycotts are illegal *per se* under the Sherman Act because they are naked or unreasonable restraints of trade with no purpose except stifling competition. Unless there is a specific exemption from the antitrust laws, the boycott will be considered a predatory practice or competition stifling. *See also* Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd., 416 F.2d 71 (9th Cir. 1969).

215. Otto Milk Co., 388 F.2d 789, 797 (3d Cir. 1967), *see* Fairdale Farms Inc. v. Yankee Milk, Inc., *supra* note 214.

216. United States v. Mid-American Dairymen, Inc., 1977-1 Trade Case ¶ 61,509

coerce non-members into becoming members by driving prices down.[217]

The courts have occasionally indicated specific instances that were *not* predatory practices or unreasonable restraints of trade. Predatory practices in one particular situation are not always found to be so under other circumstances. Distinctions are made because of the magnitude and the effect of the offense or because some practices, not unlawful standing alone, are unlawful when coupled with more obnoxious predatory practices. These specific legitimate activities have included: (1) announcing negotiable premium prices, thereby unilaterally cutting off a dairy processor's profitable hauling operations, allegedly in retaliation for a processor's competing for supplies from individual farmers; (2) cutting off or threatening to cut off any customers who tried to substitute from other sources any portion of supplies usually bought from the cooperative; (3) successfully warding off the entry of potential competitors into the market by cutting off or threatening to cut off a customer's supplies in another area, in retaliation for the customer's attempt to obtain some of its supplies from a cooperative's competitors; (4) insisting on full supply contracts;[218] and (5) requiring members to remain members for a two year period.[219]

5. The Realities of Personal Liability in Antitrust Cases

The leading case holding directors and officers of a cor-

(W.D. Mo. 1977). These activities were enjoined by means of a consent decree entered into by the cooperative and the Justice Department.

217. United States v. Dairymen, Inc., 1978-1 Trade Case. ¶ 62,053 (W.D. Kentucky 1978).

218. Kinnett Dairies, Inc. v. Dairymen, Inc., 512 F. Supp. 608 (M.D. Ga. 1981). *See* United States v. Dairymen, Inc., *supra* note 217, where full-supply and committed supply (requirements contracts) were found not to be predatory trade practices. In McDill v. McDonald Cooperative Dairy Co., 283 N.W.2d 819 (Mich. App. 1979), the court construed the legality of certain exclusive hauling contracts. The court said the contracts were not in violation of Michigan antitrust laws. There, however, the cooperative had broken the valid agreement for exclusive hauling by independent haulers. The court used the "rule of reason" to uphold the exclusive hauling routes of these noncooperative haulers and assessed the cooperative damages.

219. United States v. Dairymen, Inc., *supra* note 217.

poration liable for antitrust violations is *Hartford-Empire Co. v. United States*.[220] Although the directors of a corporation may be held personally liable for antitrust violations, this case pointed out that shareholders and employees of a corporation may not have an individual claim for personal relief under the antitrust laws for injuries suffered as a consequence of injury done to the corporation. Normally, the proper course of action for this type of injury is a shareholder derivative action for breach of fiduciary duty.

There have been few cases over the years where a cooperative's officers or directors have been sued individually for violations of antitrust law. Moreover, when directors have been specifically named as defendants, they have not usually been held liable. In derivative actions against officers and directors of cooperatives, as with actions against executives of other corporations, courts generally find liability only for gross and culpable negligence in the management of the cooperative. Suggestions that directors of cooperatives should be held to a higher standard of care, similar to that imposed on trustees, have gone unheeded. The courts have held that the fiduciary relationship that exists in the cooperative setting is not the "simon-pure" relationship between a *cestui que trust* and trustees.[221] Courts have limited the liability of officers and directors of cooperatives to participation in "inherently wrongful conduct."[222] Thus, plaintiffs in antitrust suits must allege gross and culpable negligence or inherently wrongful conduct in the management of the cooperative before directors will be held liable.

Nevertheless, in areas where the Capper-Volstead exemption does not apply, the courts have sometimes been

220. 323 U.S. 386 (1945). *See* Deaktor v. Fox Grocery Co., 332 F. Supp. 536 (W.D. Penn. 1971).

221. Parish v. Maryland & Virginia Milk Producers Ass'n, 261 Md. 618, 277 A.2d 19, 48-49 (App. 1971).

222. GVF Cannery, Inc. v. Calif. Tomato Growers' Ass'n, 511 F. Supp. 711, 717 (N.D. Calif. 1981), *citing* Murphy Tugboat Co. v. Shipowners and Merchants Towboat Co., Ltd., 467 F. Supp. 841, 853 (N.D. Calif. 1979). In this case, the court held that a corporate executive will not be held vicariously liable merely by virtue of his office; rather, personal liability must be founded upon specific acts by the officer or director. *Id.* In other words, direct action, or knowing approval or ratification of inherently unlawful acts, is required.

strict with individual directors. In one case, a charge of conspiracy to restrain trade by price-fixing was inferred from course of dealing and circumstances.[223] There a cooperative raised "out-of-store" prices even though wholesale prices had not been increased, fixed different prices for different customers, gave secret cash rebates, cut prices indiscriminately without valid explanation, and utilized deceptive practices and bullying methods. The antitrust exemptions did not apply because the actions of the cooperative (supplier) affected others (customers); therefore the defendant-cooperative was subject to the antitrust laws.[224] The court said that the fixing of retail prices was in violation of Section 1 of the Sherman Act, and that the predatory acts showed intent to monopolize in violation of Section 2. The court awarded damages against the defendants, as well as attorneys' fees, and issued an injunction prohibiting the cooperative's unlawful actions.[225]

In another private antitrust action against a farmers marketing cooperative in which officers and directors were also named defendants, the court held that a corporate officer acting in his official capacity can individually perform predatory acts for which he is personally responsible.[226] The court said the corporation as principal is responsible for the acts of its agents which violate the antitrust laws, but the agents can also be individually responsible. The court said further that officers or directors, acting in other than their normal capacity, can be held individually responsible for conspiracy to monopolize, and the corporation as principal may also be responsible for their violations.[227]

223. Bergjans Farm Dairy Co. v. Sanitary Milk Producers, 241 F. Supp. 476, 482 (E.D. Mo. 1965).

224. *Id.* at 482.

225. *Id.* at 483, 487. The court also found that the dairy cooperative and manager had violated § 2(a) of the Clayton Act, as amended by the Robinson-Patman Act, 15 U.S.C. § 13(a) (1976), by unlawful price discrimination. *Id.* at 489.

226. Shoenberg Farms, Inc. v. Denver Milk Producers, Inc., 231 F. Supp. 266, 267 (D. Colo. 1964), *citing* Lorain Journal Co. v. United States, 342 U.S. 143 (1951); *see also* Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd., 416 F.2d 71 (9th Cir. 1969); *but see* Green v. Associated Milk Producers, Inc., 692 F.2d 1153 (8th Cir. 1982).

227. 231 F. Supp. at 269-70.

6. State Antitrust Laws

Forty-eight states have statutes concerning agricultural marketing cooperatives that include a provision to the effect that a cooperative incorporated pursuant to state statute does not violate the antitrust laws of the state either by operations or by agreements with members.[228] Another common statutory provision does not refer specifically to antitrust rules but permits activities among cooperative associations that might otherwise have antitrust implications. Forty-three state statutes have a provision allowing inter-association agreements.[229] These types of statutes have generally been upheld by the courts.[230]

7. Conclusion on Antitrust Liability

Although there are few civil cases actually holding directors of cooperatives personally liable for antitrust violations, the potential for civil liability is as great as under many other legal theories. The potential for criminal liability is also considerable. Even though the specific applicability of the various laws to individual circumstances is uncertain, the existence of criminal sanctions and civil remedies based on those laws is certain. Increased enforcement of the antitrust laws by the Justice Department and the Federal Trade Commission could result in more fines and even jail sentences being imposed against cooperative directors. Additionally, it may only be a matter of time until more civil suits are brought against directors personally. Civil suits under the antitrust laws expose the director to liability under general tort law for the consequences of his actions. He

228. J. BAARDA, *supra* note 100, at 128. *See, e.g.*, ARK. STAT. ANN. §§ 77-925, 77-1022 (Repl. 1981).

229. J. BAARDA, *supra* note 100. *See, e.g.*, ARK. STAT. ANN. §§ 77-922, 77-1016 (Repl. 1981).

230. Legal Phases of Farmer Cooperatives 273-274, U.S. Dept. of Agriculture, Farmer Coop. Ser. Inf. 100. *See, e.g.*, Rifle Potato Growers' Co-op Ass'n v. Smith, 78 Colo. 171, 240 P. 937 (1925); Kansas Wheat Growers' Ass'n v. Schulte, 113 Kan. 672, 216 P. 311 (1923); Brown v. Staple Cotton Co-op Ass'n, 132 Miss. 859, 96 So. 849 (1923); Stark County Milk Producers Ass'n v. Tabeling, 129 Ohio St. 159, 194 N.E. 16, 19 (1934); and List v. Burley Tobacco Growers' Co-op Ass'n, 114 Ohio St. 361, 151 N.E. 471 (1926).

could also be liable under Section 14 of the Clayton Act. He could be personally liable for violations of Section 1 or 2 of the Sherman Act. He could be liable under the Robinson-Patman Act for discriminatory pricing practices or for authorizing inordinately low prices without a legitimate commercial objective. Finally, he could be sued in a derivative action for a violation of his fiduciary duty to the cooperative.

F. Indemnification and Insurance

Because of the possibility that even the most careful, faithful, and knowledgeable director may become a defendant in a lawsuit because of his official actions or position, some thought should be given to protecting the director through indemnification and insurance.

1. Indemnification

Indemnification is the reimbursement of a director for expenses resulting from legal actions taken against him in his official capacity. In the typical case, the director is sued by a third party or by members or shareholders of the cooperative in a derivative action. A director can incur expenses of counsel, court, and settlement or judgment. Depending on the nature of the legal action, it may be possible for the director to be reimbursed for some or all of these expenses through indemnification by the cooperative.

There are corporate statutory provisions for indemnification in every state.[231] These statutes apply to corporate directors and therefore to the directors of incorporated cooperatives. Most statutes are a recognizable version of the MBCA Section 5, which, as revised in 1980, provides for and puts limitations on indemnification. A director may be indemnified for some or all expenses by right or by discretion. But under some circumstances, he may be barred from indemnification altogether.

In order to qualify for indemnification, it must be determined that the director of a cooperative has met the pre-

231. W. KNEPPER, *supra* note 23, at 590.

scribed standard of conduct of the MBCA[232] or the cooperative's bylaws. In one recent case, an employee of a cooperative was denied indemnification when he was found guilty of making illegal campaign contributions in which the directors had acquiesced. A bylaw allowed indemnification to the extent permitted by law, but only for acts done in good faith. The court held that a knowing violation of the law, though done to benefit the cooperative, was not an act in good faith. The employee was left to pay the fine and attorney fees out of his own pocket.[233]

Nevertheless, directors have been indemnified by right even though they had not been found innocent. In one case, directors were convicted of securities violations. After reversal of the convictions, they were retried. The suit was finally settled by pleas of nolo contendere. The directors agreed not to appeal in return for additional charges being dropped. The business resisted a demand for indemnification, claiming the directors had not made a successful defense. The court held that any outcome to a criminal charge other than a conviction was successful for purposes of indemnification, and that there could be partial indemnification on any successfully defended independent count.[234]

2. Insurance

Business organizations are looking more frequently to insurance policies to cover director liability. The general increase in litigation with directors as defendants and the high cost of litigation have recently prompted a demand for and availability of insurance policies which are intended to accomplish the twin goals of insuring directors against liabilities not covered by indemnification and indemnifying the

232. *See* M.B.C.A. § 5(b)(1)-(3) (Amend. 1981).

233. Associated Milk Producers, Inc. v. Parr, 528 F. Supp. 7 (E.D. Ark. 1979).

234. Merit-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Supp. 1974). It is also possible under § 5 for the director to be indemnified in advance of the final disposition of the proceeding. This requires that the director affirm his innocence and give a written undertaking to repay the amount received if he is found to have not met the standard of conduct necessary for indemnification. *See* M.B.C.A. § 5(f)(1), (2) (Amend. 1981).

business organization when it suffers a loss in indemnifying the director.

As a primary matter, each cooperative must decide for itself whether insurance of this type (commonly referred to as a director and officer or D&O policy) is a worthwhile investment, since costs and risks will vary in almost every case.

The following are brief suggestions for protecting directors by indemnification and insurance:

(1) Provide in a bylaw that directors shall be indemnified to the full extent permitted by law.
(2) Include in the bylaw specific provisions relating to settlements, partially successful defenses against multiple charges, and expenses in defending against securities law violations where acts are not deliberately wrongful.
(3) When applying for insurance, poll each director individually to avoid misrepresentative answers in the application which, as warranties, may allow the insurer to avoid liability.
(4) To reduce expense, when deciding whether to insure, shop around for low premiums, consider a high deductible, consider a special policy limited to a particular risk or event, and consider insuring only the directors, and not the cooperative, for expenses of indemnification.[235]

II. CONCLUSION

The scope of business activities in which agricultural cooperatives engage has grown in recent years. At the same time, government regulation has grown to amend and add to the common law duties of directors. Demands on directors are now more numerous and increasingly complex. Accordingly, directors' potential personal liability has increased.

There are several hazards associated with the status of being an agricultural cooperative director. Perhaps the most pervasive risk results from the inexperience of directors who are elected from the ranks of the membership. The problem

235. *See* W. KNEPPER, *supra* note 23, at 626-28; and Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 *Bus. Law* 1993 (1978).

of inexperience is compounded by the high standards of fiduciary duty imposed on directors, the strict statutory requirements, and the litigious tendencies of our society. Consequently, directors must exercise great vigilance while carrying out their responsibilities in order to avoid personal liability.