Cooperatives, Securities Violations, and Advisor Liabilities: A Case Study

by

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This article describes facts and actions leading to liability of a cooperative's attorneys and accountants for securities law violations. The cooperative, through conflicts of interest and failure of those charged with conducting its affairs to meet their responsibilities, purchased a gasohol plant that sent the cooperative into bankruptcy. A "demand note" financing system was conducted in violation of securities laws. Directors, management, and professional advisors were held liable for losses suffered by the cooperative and investors.

This article describes recent litigation involving an Arkansas farmer cooperative, Farmers Co-op of Arkansas and Oklahoma, a complex case involving numerous issues in addition to those discussed herein.[1] This civil liability litigation arose from two distinct episodes of securities law violations. The first set of violations grew out of the cooperative's acquisition of another corporation's stock. The cooperative, through its trustee in bankruptcy, was the plaintiff in litigation based on the acquisition. The second set of actions involved the cooperative's sale of investment securities in the form of demand notes. Plaintiffs were cooperative members and members of the general public as a class.[2]

Primary liability was imposed on the cooperative's directors and officers. However, this article focuses on events leading to liability imposed on accountants and attorneys acting as the cooperative's professional advisors. The purpose of the article is to describe events and actions leading to accountants' and attorneys' liability for securities regulation violation. Securities regulation, federal and state, is summarized only briefly to place events and actions in context.[3]

Primary and Secondary Liability

Persons designated primary violators are specified in various sections of the 1933 and 1934 federal securities laws.[4] Primary liability may be incurred by persons having special relationships with investors or with greater access to material information.[5] Primary violators include those who sign registration statements; directors or partners of the issuer; every

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accountant, engineer, or appraiser whose profession gives authority to a statement; and underwriters of the security.[6]

Civil liability also arises when one offers or sells, by use of any means or instrumentality of interstate commerce, a security that either omits or misstates a material fact. This may be done by a seller or the seller's agent or broker as well as a buyer's agent or broker.[7]

The ability of one to control any person liable under provisions of the federal securities acts was expressly recognized by Congress in both the 1933 and 1934 acts. The "controlling person shall be jointly and severally liable with and to the same extent as such controlled person."[8] As demonstrated in the Arkansas litigation, courts may interpret control to include a defendant's "power to protest the way in which its name was used to project materially misleading information."[9] When asked to approve materials to be published, the defendant "chose not to exercise its prerogatives."[10]

The federal securities laws also generally contain antifraud provisions.[11] These provisions were not intended to encompass "simple corporate mismanagement or every imaginable breach of fiduciary duty in connection with securities transactions."[12] Nevertheless, to maintain the integrity of the securities market, liability has extended to any person who acted "in connection with" securities violation under the antifraud provision.[13]

Section 10b of the 1934 act makes it unlawful to purchase or sell a security using "any manipulative or deceptive device or contrivance" in contradiction to the Securities and Exchange Commission (SEC) rules.[14] Rule 10b-5 states

> it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[15]

It is also unlawful to make any untrue statement, omit a material fact, or engage in any act that operates as a fraud in connection with purchase or sale of any security.[16]

Rule 10b-5 does not expressly provide for a private cause of action. However, courts have consistently recognized such a right for 40 years.[17] Persons primarily liable, those having specific relationships with the injured parties identified by the securities acts, are subject to civil suit.[18] In many instances, however, by the time the fraud has been discovered, the party primarily liable is either bankrupt or insolvent.[19] Thus, those persons who sold or purchased securities in a fraudulent transaction may sue those who acted "in connection with" the fraudulent activity, providing the "deep pockets" necessary for recovery.[20]

Secondary liability may be established through a variety of theories,

including agency principles, conspiracy, tort, contribution, and indemnification as well as aiding and abetting. Aiding and abetting occurs "when [someone] knows or is reckless in not knowing that a violation is occurring and he renders substantial assistance either by remaining silent or inactive when he has a duty to speak or act, or by taking an affirmative action."[21] The courts have used the language of the Restatement of Torts in creating the aiding and abetting cause of action because it "surely best fulfills the purposes of the Securities Exchange Act of 1934."[22]

The three elements required for finding one liable for aiding and abetting are: (1) existence of an independent wrong, a primary violation, (2) knowledge of the wrong by an aider or abettor, and (3) substantial assistance by the aider or abettor in the execution of that wrong.[23]

The Restatement of Torts provides a five-element test for determining substantial assistance.[24] Courts, however, prefer to focus on conduct in connection with "various affirmative acts, including misrepresentations and participation in the preparation of misleading documents."[25]

The Arkansas antifraud securities section provides "any person who . . . offers or sells a security by means of any untrue statement of material fact or any omission to state a material fact necessary to make the statement made, in light of circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission) . . . is liable to the person buying from him. . . ."[26] Although the language of this statute refers to "sellers," the Arkansas blue sky law expands liability, stating "every person who controls a seller . . . every partner, officer, director . . . every person occupying a similar status or performing a similar function, every employee of such seller . . . who materially aids in the sale . . . [is] also liable jointly and severally with . . . the seller. . . ."[27]

Under antifraud statutes, it is not fraud if there was an honest belief in the representations and they were carried out in good faith, no matter how inaccurate the statements turn out to be. However, no amount of honest belief that a scheme or plan will ultimately make a profit for investors is a defense for fraudulent activity.[28]

The Litigation

A year after Farmers Co-op of Arkansas and Oklahoma filed for reorganization under Chapter 11 of the Bankruptcy Code on February 23, 1984, the trustee in bankruptcy, Thomas Robertson, Jr., filed a lawsuit against individual managerial employees, all the cooperative's directors who had served between 1974–84, and accountants and attorneys the cooperative had retained during that period.[29] Examination of the cooperative's state of insolvency led Robertson to conclude it had been run in a negligent, fraudulent, and reckless manner by those entrusted with responsibility for conducting its affairs.[30] Robertson's action was based on alleged securities violations growing out of the cooperative's acquisition of the stock of a gasohol plant, White Flame Fuels, Inc.[31] Joining Robertson in the suit was a class of demand note holders who claimed financial statements presented to cooperative members and public investors fraudulently misrepresented the cooperative's financial status upon and after acquisition of White Flame Fuels.[32]

A number of the defendants, including the directors, settled before the case went to the jury.[33] By October 16, 1986, $8.2 million had been received by plaintiffs in settlement.[34] Division of the settlement was $2.6 million to the cooperative (by way of the trustee) and $5.6 million to the class of demand note holders.[35]

For those whose liability was determined by the jury, awards were granted plaintiffs of $2,732,000 against attorneys involved in the gasohol plant acquisition[36] and $6,121,652.94 against accountants for securities fraud in connection with the sale of demand notes.[37]

History

Farmers Co-op of Arkansas and Oklahoma was organized in 1948. In 1952, the cooperative hired Jack White as its general manager.[38] With a large commercial facility located near the Arkansas River, the cooperative developed an extensive operation in western Arkansas and eastern Oklahoma.

In late 1975, the Internal Revenue Service (IRS) began an investigation of White and Gene Kuykendall, auditor/accountant, for tax fraud regarding the cooperative's 1973 and 1974 tax returns.[39] In May 1977, the cooperative authorized White, signatory of the tax returns, to retain the law firm of Ball, Mourton & Adams to defend him in the IRS's criminal investigation.[40] In September 1980, a federal grand jury indicted White and Kuykendall for engaging in a pattern of self-dealing with the cooperative and juggling the books to conceal their "predatory" behavior.[41] In September 1981, White and Kuykendall were convicted on all counts, and one year later the Eighth Circuit confirmed the convictions.[42]

Board members continued to support White by explaining the convictions were based on "at most technical violations of the tax laws and no transactions detrimental to the Co-op had been shown."[43] On March 18, 1982, the cooperative's board of directors gave White a six-month leave of absence so he could serve his prison sentence for criminal tax fraud. White continued to serve as general manager until 1983.[44]

The Gasohol Plant

Two years before White's conviction, he had become involved with an enterprise called Big D & W Refining and Solvents, Inc., which later changed its name to White Flame Fuels, Inc.[45] White began construction of the gasohol-producing plant in June 1979. White owned 50 percent of this venture, with Edwin Dooley owning the remaining half.[46] Although White suggested his 50 percent interest was always owned by the cooperative, he claimed White Flame Fuels' entire loss on his 1979 income tax return.[47]

Within a few months of beginning construction on the plant, White bought Dooley's shares, agreeing not to hold Dooley responsible for the $1.2 million they had borrowed to finance the operation.[48] The White Flame Fuels' financial statement for that year, 1979, had been prepared by Kuykendall and showed a net worth of $350,000 when, in fact, White Flame Fuels was insolvent. The gasohol plan and equipment had been carried on the balance sheet at their purported cost of $1.5 million.[49]

To finish construction and begin operation, financing of $3 million was necessary. Arkansas Act 9 industrial development bonds seemed to be the answer,[50] but bond counsel found the plant to be a high risk, unsuitable for investment purposes. The offering statement reported White Flame Fuels "was a new entity with no operating history of any type, whose management had no experience, proposing to use an untried process with no assurance of mechanical success."[51] The statement also noted White Flame Fuels "had no contracts to purchase raw materials and no market for its product, no personnel with technical proficiency and no assured demand for its product."[52]

Neither could White obtain financing from conventional lenders who required proof the plant could produce at 90 percent capacity for 60 days. The plant could produce only at 25 percent capacity, and alcohol it did produce was of inferior quality.[53] White turned to the cooperative's cash funds for financing. From January 17, 1980, through October 9, 1980, White signed promissory notes to the cooperative, as much as $1 million per note, taking a total of $4 million with no security other than his personal guarantee.[54] White signed these promissory notes twice, once "as an individual" and once on behalf of White Flame Fuels.[55] The Chapter 11 trustee believed these loans were either unauthorized, made through deception of the board of directors, or through negligence or collusion on the part of the cooperative's controller.[56]

The board seemed to have justified these large loans to White with the idea that in 1979 a gasohol plant using agricultural products was "a darned good idea" and a person who built one was a "national hero."[57] White Flame Fuels began production in 1980 but never produced more than 25 percent capacity. It lost $100,000 a month.[58] By the end of 1980, White was in "financial straits" because he had guaranteed White Flame Fuels' debt to the cooperative. The plant was "plagued with cost overruns" and, if the cooperative chose to call in those loans "due on demand," White stood to lose his entire personal fortune.[59]

On November 12, 1980, the board of directors held a meeting, the handwritten minutes of which reflect the first reference to a cooperative plan to purchase the plant from White. "Waldo made motion Jimmy second the Co-op buy the gasohol plant motion carried."[60] These minutes indicate no contract terms, either as to price or time.

Farmland Industries, the cooperative's principal supplier and largest single creditor, "advised against acquisition."[61] The decision to purchase, however, had been made—the only question remaining was how. It appears the issue was whether transfer of White Flame Fuels' stock as late as November would still entitle the cooperative to investment tax and energy credits for 1980.[62] If documentation showed the cooperative owned the gasohol plant prior to the date production commenced, the cooperative could take advantage of available tax credits. If the plant was still in the research and development phase prior to acquisition by the cooperative, credits accrued to the entity that actually placed the plant into commercial production.[63]

Because the plant had started making sales in April 1980,[64] the research and development phase had passed. In a meeting on November 25, 1980, the suggestion was made to simply "backdate"[65] the stock certificates but

was quickly dismissed as the type of fraud that was "pretty ease to prove."[66] A "friendly lawsuit" in chancery court was considered a way to "finalize" the desired date of acquisition.

On November 26, 1980, a complaint was drafted affixing the "date of acquisition" as January 1, 1980.[67] In a letter from P. H. Hardin, the attorney who drew up the original complaint, to Carl Creekmore, the cooperative's general counsel, the proposed decree was to be reviewed and discussed. A handwritten notation at the bottom of this letter reads, "E.J. [Ball], what do you think? If you have suggested changes please call me re same as I have this set up on tape, H."[68]

In the redraft, the date of acquisition was changed from January 1 to February 15, 1980. The final complaint in the "friendly lawsuit" also made the cooperative responsible for White's $250,000 note obligation to Citizen's Bank and classified $4 million lent to White as "cooperative investments" in the plant.[69] The stock transfer was decreed by Chancery Court of Crawford County, Arkansas, on December 19, 1980, with the "equitable transfer of all capital stock" dated February 15, 1980.[70]

The decision to base the transfer on stock rather than purchase of the assets had been discussed by the controller Kirit Goradia, Kuykendall, and attorney Ken Mourton in two separate meetings with an accounting firm.[71] Discussion suggested simply buying the assets "would not be good"[72] because the investment credit would disappear at the point the corporation disappeared.

For an investment tax benefit of any significant amount, the transfer necessitated a stock acquisition rather than purchase of assets. Additionally, "in order to obtain any investment credit, the cooperative would have had to have purchased the White Flames stock prior to the date that the gasohol plant . . . was first placed in service."[73] Therefore, the final complaint stated that White Flame Fuels "was and is of substantial interest" to the cooperative; the cooperative made loans to White on the assurance of receiving material benefits from White Flame Fuels; in January 1980, an additional loan was made to White from the cooperative in the amount of $750,000; and in February 1980, it became apparent that to protect its loan, the cooperative "would have to loan in excess of $1,500,000" to White for payments on notes due at the Merchant's National Bank in Fort Smith, Arkansas.

The complaint further stated White "assured" the cooperative White Flame Fuels' entire stock would become the property of the cooperative and upon these assurances all money lent White from the cooperative "would be considered as the Co-op's investment in White Flame Fuels." It also was stated that an additional $1,430,000 was invested by the cooperative in February 1980. In reliance on assurances provided by White and "upon the belief and premise" White was the "sole and only stockholder of White Flame Fuels," another $2,980,000 was invested by the cooperative between February 15 and October 29, 1980. In section VIII of the complaint, explanation for the nonexistence of a written agreement between the cooperative and White Flame Fuel is stated as an existing relationship of "trust and confidence." Paragraph 5 of section IX of the complaint asserts that all amounts lent to White were to be cooperative investment and that White "shall be relieved and forever discharged" for any amounts.[74]

In the cooperative's 1980 financial statement, losses incurred by White Flame Fuels during that year, in excess of $1 million, were not reported. As a result, the cooperative reported a profit.[75] Kuykendall, White Flame Fuels' independent auditor for 1980, testified he "got up" a figure for White Flame Fuels overnight.[76] It appears he took all the money spent on the gasohol plant and arbitrarily capitalized 80 percent of it, expensing out the remaining 20 percent. Kuykendall "candidly admitted that expenses were figured at 20% because otherwise the gasohol plant would have shown a 'tremendous big loss' for 1980."[77]

Due to the suspiciousness of a 20 percent across-the-board expense rate for 1980, Kuykendall fortuitously rated the various expenditure categories at 23 percent, 18 percent, and 19 percent.[78] Arthur Young & Co. accountants, serving as cooperative auditors, testified they independently arrived at a figure for the cost of the gasohol plant on the cooperative's 1980 statement. Coincidentally, the Arthur Young figures matched "to the penny" those figures reported by Kuykendall in his White Flame Fuels' audit.[79]

The Demand Notes

At this point, the accountant's actions became intertwined with demand note sales and provided the foundation for aiding and abetting a securities fraud scheme. Under the cooperative's demand note system, anyone could invest in a demand note. The cooperative was obligated to redeem notes, with stated interest, at the demand of the investor. The notes were unsecured and represented a substantial portion of the cooperative's financial structure.

White Flame Fuels' assets were reported in the cooperative's financial statements for 1980, 1981, and 1982 at a value exceeding $3 million when the correct value was "probably less than $500,000."[80] In 1981, 1982, and 1983, Arthur Young & Co., the cooperative's auditors, gave unqualified opinions with a footnoted reservation that read, "Some doubt as to the recoverability of the Co-op's investment in White Flames."[81]

By the March 1983 annual meeting, the cooperative's investment in White Flame Fuels exceeded $7 million. A "condensed" version of the Arthur Young audit findings was printed and circulated among members and noteholders.[82] This "condensed" version excluded the accountant's explanatory notes or reservations. Until January 1984, when the cooperative filed for bankruptcy, newsletters encouraging depositors to place their savings in the "safe, secure" cooperative repeatedly used the "condensed" financial statements.[83] In late 1983, one cooperative director redeemed more than $700 thousand of his own demand notes but told others the investment program "was as safe as putting money in the bank."[84]

The trustee recognized that Arthur Young had considered whether to "recommend the write down to net realizable value" of White Flame Fuels and to issue an adverse opinion stating the cooperative financial statements were not fair representations of its financial condition.[85] Arthur Young failed to do so despite the fact it should have in accordance with generally accepted accounting principles. The court found the auditors had a choice of "really getting people's attention" by listing the "albatross" at its net realizable value or maintaining and, to an extent, "inventing" a

fiction.[86] The plant's actual worth, estimated at between $500 thousand and $750 thousand, was listed on the books at its "cost" of $4.5 million.[87]

Arkansas Securities Regulation

The cooperative had been issuing and selling demand notes to cooperative members and the general public since 1959.[88] Farmer cooperatives organized and operated under Arkansas law are exempt from registering any stock, preferred stock, promissory note, or debenture so long as proof of exemption is filed with the commissioner of the Arkansas Securities Department. Proof of exemption must contain a statement upon which grounds for exemption are claimed, such as farmer cooperative status.[89]

On December 29, 1975, White, as the cooperative's general manager, received a letter from the Arkansas Securities Department regarding the cooperative's issuance of promissory notes.[90] Although securities issued by agricultural cooperatives might have been exempt from registration, the cooperative was required to qualify for the exemption by filing with the Arkansas Securities Department.[91]

In a January 8, 1976, conference with White and Kuykendall, the Arkansas Securities Department laid out the importance and necessity of filing the requisite documents.[92] A letter dated January 16, 1976, gave the cooperative "further information on why a promissory note is a security" under either federal securities laws or the Arkansas act, reiterating "procedures to be followed . . . for exemption from registration."[93]

By April 1978, the cooperative's filing for the Arkansas act exemption had yet to be completed. A warning was issued by Arkansas securities commissioner Harvey L. Bell. The warning placed each officer and director on notice that each could be found personally liable, criminally and civilly, for noncompliance with the Arkansas laws.[94] One week later, the Arkansas Securities Department received an incomplete proof-of-exemption claim from the cooperative. The securities commissioner responded by requesting notification "at your earliest convenience whether you plan to complete the proof of exemption or withdraw the claim."[95] The Securities Department requested demand notes be sold to members only, with more detailed disclosure statements.[96]

It was during this period that the cooperative bought the White Flame Fuels' stock from White. By August 1983, the Arkansas Securities Department had categorized the cooperative's financial statements as inadequate. Although the noteholders had been informed of their unsecured common creditor status, there was concern that there be disclosure as to their subordinated status in bankruptcy proceeding. This concern seemed to stem from deterioration of the overall financial health of the cooperative as a result of the acquisition of White Flame Fuels.[97]

The history of the cooperative's relationship with the Arkansas Securities Department, as evidenced by eight years of correspondence produced at trial, resulted in contingent approval of demand note sales to members if the cooperative would properly file under the Arkansas act.[98] This contingent approval also stated that concurrence of Arthur Young "must be solicited for the use of their statements as this amounts to their being conscripted as 'experts.' "[99]

Frank discussion and full disclosure by the cooperative to noteholders as to their status in event of bankruptcy also predicated this permission by the Arkansas Securities Department on October 19, 1983. Fear such disclosure would cause a run on the cooperative it could not have absorbed appeared to the court to be the reasons for "knowingly permitting members and investors to invest and reinvest their money in the cooperative without showing them the offering statements."[100]

Liability

The jury unanimously found Arthur Young negligent in preparation and presentation of the audit report to the cooperative's board of directors.[101] The jury found the proximate cause of the cooperative's loss was failure to question the propriety of payments to White. The burden of the "negligent" behavior was shared by Arthur Young and the cooperative.

The jury did not find Arthur Young guilty of actual fraud in preparation of the audit reports of 1981 and 1982 but did find guilt under both federal and state securities fraud laws in demand note sales between April 22, 1982, and February 23, 1984.[102] Damages determined by the total number of demand notes sold during this period by means of these violations exceeded $6 million.

Liability under the Arkansas Securities Law was based on the following elements: (1) A financial statement was found to be misleading due to the omission of a material fact; (2) the cooperative omitted to tell the noteholders facts necessary to make the statements not misleading; (3) the statements or omissions originated with Arthur Young; (4) a reasonable person would foreseeably rely to their detriment, whether such reliance actually occurred or not; and (5) Arthur Young knew these statements or omissions were false or made them recklessly. Recklessly was defined to the jury as acting in disregard of a risk whether there was truthful basis in the representation or, in the case of an omission, recklessly disregarding the material nature of that omission.[103]

Under federal securities laws' antifraud provisions, the jury needed to find Arthur Young either omitted or made untrue statements of a material fact; the actions were in reckless disregard for the truth, the noteholders justifiably relied on the statements, and they were the proximate cause of damages suffered by noteholders; and Arthur Young used instrumentalities of interstate commerce.[104] Arthur Young argued no one specifically relied on the misrepresentations.[105] However, reliance is irrelevant under the Arkansas Securities Act,[106] and actual reliance need not be established under the federal securities acts;[107] there need only be omitted facts of a material nature. Securities laws are designed to protect the gullible and unsophisticated as well as the experienced investor. Omission or misstatement of a material fact is one that would have been significant to the decision of a reasonable investor; a reasonable investor is not necessarily one of ordinary intelligence.[108]

The instrumentalities-of-interstate-commerce element could be satisfied without Arthur Young being involved, directly or indirectly, in any mailing. Nor was it necessary that items sent through the mails contain any fraudulent or objectionable material. The use of the mails need not be central

to the plan's execution. It was necessary only that the mails bear some relation to the object of the scheme.[109]

The jury found the attorneys guilty of federal or state securities fraud in facilitating the stock transfer from White Flame Fuels to the cooperative.[110] Under the antifraud provisions of the federal securities laws, the jury had to find that "in connection with" stock transfer the attorneys employed a device, scheme, or artifice to defraud; omitted or made an untrue statement of material fact; or engaged in an act that operated as a fraud or deceit upon the seller or purchaser.[111] Any one of these three elements would suffice. A device, scheme, or artifice is defined as any plan for the accomplishment of an objective, and it need not relate to the investment value of the securities involved.[112] It was no defense that the attorneys were not involved from the beginning or only a minor role was played. There had only to be a substantial nexus or relation "in connection with" the plan, not personal misrepresentation of facts or omissions.[113] "There is no evidence to suggest that any of the accountants or the lawyers were in privity with any of the purchasers," nor did it appear to the court that either group "performed any act which was a substantial factor in causing any one sale to take place,"[114] in the sense of "seducing the prey and leading it to the trap."[115] An "inducing cause of the sale,"[116] although necessary under the federal securities law, is not necessary under the state securities act. In Arkansas, "active participants" who aid or abet commission of a tort are jointly and severally liable.[117]

Under antifraud provisions of the Arkansas Securities Act, the jury had to find that White offered or sold a security to the cooperative by means of either an omission or an untrue statement of material fact of which the cooperative was unaware. It also had to find that the attorneys were either employees of White who materially assisted the sale or that they were the cooperative's fiduciaries owing it a duty to not materially assist the transaction because of facts or circumstances known to them.[118] The jury was instructed that matters of public record affecting one's interests are chargeably known to the individual.[119] Arkansas case law has found that "the burden of establishing the fairness of a transaction is on the attorney"[120] and White's indictment should have been "sufficient notice."[121]

Sale of demand note "securities" had been going on since 1959; thus the court found none of the defendants had "commanded, directed, advised or encouraged the sale of unregistered demand notes."[122] Interestingly, the court found that at "no time" were either the attorneys or the accountants under any duty to perform an independent analysis of their client's financial practices to ensure compliance with state and federal laws. To impose this responsibility, a position the trustee urged, "would go far toward making the accountant . . . an enforcement arm of the SEC."[123]

Directors' Role

Although directors had been found liable for securities law violations previously[124] and had agreed to pay damages prior to trial to settle all claims against them, the court and jury also noted the directors' role in securities violations leading to accountant and attorney liability. A number

of board actions or failures to act, detailed in the complaint,[125] resulted in negligence contributing to the cooperative's problems.

The jury found that the cooperative's directors and employees had been contributorily negligent in the damages sustained by the cooperative after April 22, 1982.[126] This was the date from which Arthur Young had been held liable for securities violations resulting from the negligently prepared financial statements. A director is presumed to have competent knowledge of the cooperative's books and records as well as knowledge of the directors' own duties.[127] Ignorance is no defense if it is the result of inattention, negligence, or shirking of responsibility. The failure of a director to become acquainted with director duties and the business matters of the cooperative is failure to exercise due care.[128]

The court found that after White's and Kuykendall's indictments, in "any transaction involving White and the Co-op . . . red flags abounded to those who wanted to see them."[129] Apparently, the directors did not see them because the indictment did not prompt an investigation by the board as to the economics of the acquisition. Nor was it "obvious" to "any director with the most basic understanding . . . and a conscientious concern for the welfare of the Co-op"[130] that it could not remain in business if it acquired White Flame Fuels.

Another departure from the exercise of due care by the board occurred after White's conviction. In 1982, the cooperative leased White Flame Fuels back to White giving him 50 percent of the net profits of the plant. Animal feed, a by-product of the gasohol plant, purportedly had a $90 to $150 per ton value at the time. The trustee claimed White sold this feed to Valley Feeds, another entity White controlled, at 30–50 percent of its value, profiting from the difference.[131]

Conclusion

The episode, a portion of the events of which are described in this article, is a dramatic illustration of the importance of educating all who are or may be involved with an agricultural cooperative that deals in securities. It is essential for those in positions of responsibility to be fully advised of the applicability of registration requirements, methods of obtaining an exemption when available, and, under any circumstances, the importance of a policy of full and accurate disclosure.

This case stands as a warning to those involved with cooperatives, whether as directors, employees, or outside professional advisors such as attorneys and accountants, that they are not "out of the bounds" of regulations designed to protect the public, nor in a special category under securities laws of their respective states or the federal government. When other people's money is involved, the law expects fair and honest dealing. "In the twilight of the twentieth century it should hardly come as a surprise that government pervasively regulates the broad-scale solicitation of capital for investment."[132]

Cooperatives must have open and informed management-level discussions about the issuance of security instruments. Directors are especially vulnerable to errors based on uncertainty about technical matters or undue reliance on professional advisors.[133] In working with retained accountants

and attorneys, the constant concern of possible securities issues must be stressed as well as the need for continuous counsel so "issues" can be addressed as they arise.

While the facts of the Farmers Co-op of Arkansas and Oklahoma case are extraordinary, they nevertheless demonstrate how people of good will and honest intention can find themselves dragged into a costly nightmare; costly in personal, financial, and professional terms as well as in terms of the life of the cooperative.

Notes

1. Robertson v. White, 633 F. Supp. 954 (W.D. Ark. 1986).

2. *Robertson*, 633 F. Supp. 954, discusses standing of plaintiffs with respect to various causes of action introduced in the consolidated complaint.

3. For information on cooperatives and securities *see generally*: Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Laws and Tax Treatment*, 21 Willamette L. Rev. 225 (1985); Weiss, *Reasons for and Cost of Registration of Agricultural Cooperative Securities*, Agric. L. J. 201 (1981–82 Annual); Weiss and Crosland, *Fact vs. Fiction in Regulation of Cooperative Securities*, 31 Cooperative Accountant 15 (Spring 1978); M. Matthews, Financial Instruments Issued by Agricultural Cooperatives, USDA, Research Report (In press); 14 N. Harl, Agric. Law § 136 (1984); J. Baarda, State Security Law Exemptions for Farmer Cooperatives, USDA, ACS Staff Report (Nov. 1984); and D. Fee, A. Hoberg, and L. McCormick, Director Liability in Agricultural Cooperatives, USDA, ACS Coop. Information Rept. 34 (Dec. 1984).

4. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78hh (1982).

5. 15 U.S.C. § 77k (1982). *See also*, Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2nd Cir. 1973), *cert. denied*, 414 U.S. 910, 38 L. Ed.2d 148, 94 S.Ct. 231, 94 S.Ct. 232, and *cert. denied*, 414 U.S. 924, 38 L. Ed.2d 158, 94 S.Ct. 234 (1973).

6. 15 U.S.C. § 77k(a)(1)–(5) (1982). *See also*, Stewart v. Bennett, 359 F. Supp. 878 (D. Mass. 1973).

7. 15 U.S.C. § 77l(2) (1982); 15 U.S.C. § 78j (1982).

8. 15 U.S.C. § 77o (1982); 15 U.S.C. § 78j (1982).

9. Ark. Stat. Ann. § 67-1256(b) (1980, 1985 Supp.) *See also*, Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104, 123 (W.D. Ark. 1949). *See also*, Robertson v. White, 633 F. Supp. 954 (W.D. Ark. 1986), Honorable F. Waters, Memorandum Opinion, Oct. 15, 1986 (on file in the United States District Court of the Western District of Arkansas) [hereinafter cited as Mem. Op.].

10. Mem. Op., *supra* note 9, at 103.

11. 15 U.S.C. § 78j (1982); Securities Exchange Act Rule 10b-5.

12. St. Louis Union Trust Co. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040 (8th Cir. 1977), CCH Fed. Secur. L. Rep. para. 96,151, *cert. denied*, 435 U.S. 925, 55 L. Ed.2d 519, 98 S.Ct. 1490 (1977).

13. 15 U.S.C. § 78j (1982).

14. 15 U.S.C. § 78j(b) (1982).

15. 15 C.F.R. § 240.10b-5(a) (1982).

16. 15 C.F.R. § 240.10b-5(b), (c) (1982).

17. This right was first implied in Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1946). ("The existence of this remedy is simply beyond peradventure."); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730, 95 S.Ct. 1917, 44 L. Ed.2d 539 (1975).

18. 15 U.S.C. § 771 (1982).

19. R. Jennings & H. Marsh, Securities Regulations Cases and Materials 1133–37, 1134 (5th Ed. 1982) See also, McDermott, *Aiding and Abetting Under Rule 10b-5*, 62 Tex. L. Rev. 1087, 1088 (1984).

20. 15 C.F.R. § 240.10b-5 (1982); McDermott, *supra* note 19, at 1089.

21. 5 A. Jacobs, The Impact of Rule 10b–5, § 40.02, at 2-117 (1980). *See also*, McDermott, *supra* note 19, at 1087.

22. Brennan v. Midwestern Life Ins. Co., 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

23. SEC v. Coffey, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908, 95 S.Ct. 826, 42 L.Ed. 2d 837 (1975); Landy v. FDIC, 486 F.2d 139, 162 (3d Cir. 1973). Knowledge also includes recklessness in not knowing.

24. Restatement Second of Torts § 876 comment d (1979). The five factors relevant in determining whether assistance is "substantial" are: (1) the amount of assistance given by the defendant, (2) the defendant's presence or absence at the time of the tort, (3) the defendant's relation to the primary tortfeasor, (4) the defendant's state of mind, and (5) the nature of the act.

25. *See* note, *Rule 10b-5: Liability for Aiding and Abetting After Ernst & Ernst v. Hochfelder*, 28 U. Fla. L. Rev. 999, 1010-143 (1976). *See also*, A. Bromberg & L. Lowenfels, Securities Fraud and Commodities Fraud, § 8.5(531), at 208.20–21.

26. Ark. Stat. Ann. §§ 67-1235-67-1263 (1980, 1985 Supp.).

27. Ark. Stat. Ann § 67-1256(b) (1980, 1985 Supp.).

28. Jury Instructions Tendered at Trial at 86, Robertson v. White, 633 F. Supp. 953 (W.D. Ark. 1986) [hereinafter cited as Instructions].

29. *Robertson*, 633 F. Supp. 954, 960.

30. *Robertson*, 633 F. Supp. 953, 960.

31. Consolidated Complaint at 17–21, *Robertson*, 633 F. Supp 954 [hereinafter cited as Complaint].

32. *Id.* at 25–39.

33. Director liability in securities matters was determined by summary judgement against cooperative directors in Robertson v. White, 635 F. Supp. 851 (W.D. Ark. 1986).

34. Judgment Order at 19, *Robertson*, 633 F. Supp 954, (filed Feb. 5, 1986) [hereinafter cited as Order].

35. *Id.*

36. Jury Interrogatories at 10, Claim III (B), *Robertson*, 633 F. Supp. 954, (filed Nov. 18, 1986) [hereinafter cited as Jury]. Judge H. Waters issued a Remittitur on Feb. 5, 1987 in the Order, at 3, conditional upon an approval of settlements with the Trustee and the Class, set for March 31, 1987, of the sum of either $2,692,000 on the state law claim or $1,030,656 on the federal law claim settlement. On March 31, 1987, the approval of settlements was filed on the federal law claim.

37. *Id.* at 15, Claim VI(B).

38. *Robertson*, 633 F. Supp. 954, 960.

39. *Robertson*, 633 F. Supp. 954, 960.

40. Statement of Undisputed Material Fact at 6, *Robertson*, 633 F. Supp. 954.

41. *Robertson*, 633 F. Supp. 954, 960.

42. United States v. White, 671 F.2d 1126 (8th Cir. 1982).

43. *Robertson*, 633 F. Supp. 954, 961; Complaint, *supra* note 31, at 38.

44. *Robertson*, 633 F. Supp. 954, 961. On September 8, 1980, the cooperative's board of directors "unanimously adopted a resolution . . . exonerating White of any wrongdoing or mismanagement of any Co-op funds." (Plaintiff's Exhibit 9-112, Plaintiff's Response to Ball, Mourton & Adams motion for Summary Judgment, *Robertson*, 633 F. Supp. 954).

45. *Robertson*, 633 F. Supp. 954, 961.

46. *Robertson*, 633 F. Supp. 954, 961.

47. Mem. Op., *supra* note 9; *Robertson*, 633 F. Supp. 954, 961.
48. *Id.*
49. *Id.*
50. Mem. Op., *supra* note 9, at 25. Ark. Stat. Ann. §§ 13-1601-13-1604 (Repl. 1968) (Amendment No. 49 was repealed by Amendent No. 62, § 11. Act 9 bonds provide for issuance of revenue bonds for purposes of facilitating industrial construction.).
51. Mem. Op., *supra* note 9, at 46.
52. *Id.*
53. *Id.*
54. Complaint, *supra* note 31; *Robertson*, 633 F. Supp. 954, Plaintiff's Exhibit A (25 personally signed promissory notes dating from Jan. 17–Oct. 9, 1980).
55. *Id.*
56. Order, *supra* note 34, at 6.
57. Mem. Op., *supra* note 9, at 38.
58. *Robertson*, 633 F. Supp. 954, 961.
59. Mem. Op., *supra* note 9, at 28. White's assets consisted mainly of $1.7 million in real estate.
60. Complaint, *supra* note 31, Plaintiff's Exhibit 8.
61. Mem. Op., *supra* note 9, at 28; Complaint, *supra* note 31, at 18 para. 41(c). Farmland threatened to deny or withhold financing to the cooperative if it acquired the plant.
62. Deposition of Ken Mourton at 162–163. *Robertson*, 633 F. Supp. 954 (Discussion of meeting held with White, Kuykendall, Brewer, and Creekmore in regards to the transfer of White Flame Fuels to the cooperative) [hereinafter cited as Mourton].
63. *Id.* at 164; Mem. Op., *supra* note 9, at 29; Deposition of G. Beck at 67, Defendant's Exhibit 15, *Robertson*, 633 F. Supp. 954 [hereinafter cited as Beck].
64. Mem. Op., *supra* note 9, at 28.
65. Mourton, *supra* note 62, at 164; Deposition of E. J. Ball at 63, *Robertson*, 633 F. Supp. 954 ("I think White asked the question 'Why can't I just sign this [document] and date it February 15th.' ") [hereinafter cited as Ball].
66. *Id.* at 164; Ball, *supra* note 65, at 62. It was suggested that a declaratory judgment action would bind the IRS so in the event of litigation the tax credits would go to the cooperative.
67. Complaint, *supra* note 31, Plaintiff's Exhibit B.
68. Exhibits in support of the defendant law firm of Ball, Mourton & Adams' Reply Brief at 10, *Robertson*, 633 F. Supp. 954.
69. Complaint, *supra* note 31, Plaintiff's Exhibit B, §§ VI and IX.
70. *Id.* at Plaintiff's Exhibit D.
71. Mourton, *supra* note 62, at 169; Beck, *supra* note 63, at 65.
72. Beck, *supra* note 63, at 65.
73. *Id.* at 67.
74. Complaint, *supra* note 31, Plaintiff's Exhibit B.
75. *Id.* at 26, para. 57, 58 at 30, para. 61(b)(c).
76. *Id.* at 31, para. 61(c); Mem. Op., *supra* note 9, at 72.
77. Mem. Op., *supra* note 9, at 72–73.
78. *Id.*
79. *Id.* at 72.
80. *Robertson*, 633 F. Supp. 954, 963; Complaint, *supra* note 31, at 26.
81. *Robertson*, 633 F. Supp. 954, 963; Mem. Op., *supra* note 9, at 78.
82. *Id.*
83. Complaint, *supra* note 31, at 37, para. 77, 78.
84. *Id.* at 38, para. 80.
85. *Id.* at 27, para. 60(a) (b).

86. Mem. Op., *supra* note 9, at 70.
87. *Id.*
88. Mem. Op., *supra* note 9, at 82.
89. Ark. Stat. Ann. § 67-1248(a)(12)(i) and (e) (1980, 1985 Supp.).
90. Complaint, *supra* note 31, Plaintiff's Exhibit F.
91. Ark. Stat. Ann. § 67-1248(a)(12) (Supp. 1973), Section 14(a) (12) of the Arkansas Securities Act of 1959.
92. Complaint, *supra* note 31, Plaintiff's Exhibit C.
93. *Id.* at H.
94. Complaint, *supra* note 31, at K.
95. *Id.* at L.
96. *Id.* at M.
97. *Id.* at N.
98. *Id.* at O.
99. *Id.* at N and O.
100. *Robertson*, 633 F. Supp. 954, 964.
101. Jury, *supra* note 36, at 12, Claim V(A).
102. *Id.* at 14, Claim V(E), at 15, Claim V(A).
103. Instructions, *supra* note 28, at 84.
104. *Id.* at 105–106.
105. Mem. Op., *supra* note 9, at 96.
106. Instructions, *supra* note 28, at 96.
107. *Id.*
108. Instructions, *supra* note 28, at 82.
109. Pereira v. United States, 347 U.S. 1, 74 S.Ct. 368, 98 L. Ed. 435 (1954); Adapted from the charge of Judge Weinfeld in United States v. Corr, 543 F.2d 1042 (2d Cir. 1976).
110. Jury, *supra* note 36, at 10, Claim III(A).
111. Instructions, *supra* note 28, at 78–88.
112. *Id.* at 80–81.
113. *Id.* at 81–82.
114. Mem. Op., *supra* note 9, at 81.
115. Pharo v. Smith, 621 F.2d. 656, 666 (5th Cir. 1980), *on reh'g*, 625 F.2d 1226 (5th Cir. 1980).
116. Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981).
117. Lewis v. Mays, 208 Ark. 382, 186 S.W. 2d 178 (1945).
118. Instructions, *supra* note 28, at 89.
119. *Id.* at 75.
120. Chavis v. Martin, 211 Ark. 80, 199 S.W. 2d 598 (1947).
121. Mem. Op., *supra* note 9, at 16.
122. *Id.* at 82.
123. *Id.*; *See also*, SEC v. Arthur Young & Co., 590 F.2d 785 (9th Cir. 1979).
124. Robertson v. White, 635 F. Supp. 851 (W.D. Ark. 1986).
125. Complaint, *supra* note 31.
126. Jury, *supra* note 36, at 17, Claim VI.
127. Olin Mathieson Chem. Corp. v. Planter's Corp., 236 S.C. 318, 114 S.E. 2d 321 (1960). *See generally*, D. Fee, A. Hoberg, and L. McCormick, Director Liability in Agricultural Cooperatives, USDA, ACS Coop. Information Rept. 34 (Dec. 1984).
128. *Id.*
129. Mem. Op., *supra* note 9, at 50.
130. Complaint, *supra* note 31, at 36, para. 75.
131. *Id.* at 22, para. 48.
132. Gould v. Ruefenacht, 471 U.S. 701, 857, 105 S.Ct. 2308, 2311, 85 L. Ed.2d 78 (1985).
133. *See*, for example, Robertson v. White, 635 F. Supp. 851 (W.D. Ark. 1986).