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# **Navigating Your Legal Duties: A Guide for Agricultural Cooperative Directors**

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## How to Use This Guide

Cooperative directors are vital to the success of their cooperatives. Directors volunteer their time and talents to lead their cooperative in its mission to serve members.

The goal of this guide is to introduce directors of agricultural cooperatives to their legal duties. It is intended for aspiring directors, directors who are new to the cooperative board, and incumbent directors who are ready for a refresher. While many of the concepts will be applicable to cooperatives broadly, the focus of the guide is on directors of agricultural marketing, purchasing, and service cooperatives. The guide includes five chapters, each covering different aspects of directors' legal duties.

Readers can review the guide in its entirety or review a single chapter that covers a topic of specific interest. Note that the guide is not a comprehensive review of every possible legal duty a director owes to their cooperative. The guide is intended to be a general overview to assist cooperative directors in understanding their basic legal duties and encourage cooperative directors to ask the right questions.

In law school, aspiring attorneys are taught that one of the most important ways they will learn to "think like a lawyer" is to "issue spot." One goal of this guide is to help agricultural cooperative directors become better issue spotters. The guide is not a manual that will explain how directors should approach or resolve legal issues. Rather, the guide is intended to introduce directors to their legal duties so that they become more aware of potential legal issues and develop habits that will help them effectively serve their cooperative while avoiding legal liability. Directors who take the care to spot potential issues can ask for help from cooperative management, experts, advisors and other professionals, such as attorneys, auditors, or accountants.

The concepts in cooperative and corporate law relating to a cooperative director's legal duties are often based in state law. This guide will discuss these concepts generally, but cooperative directors should consult with cooperative management, experts, advisors, professionals, their legal counsel, and other resources and experts to fully understand the director's legal duties as applicable to their cooperative.

Also, we would be remiss if we did not inform our readers that this guide is not intended as legal advice. **The information contained in this document is provided for educational purposes only. It is not legal advice and is not a substitute for the potential need to consult with a competent attorney licensed to practice law in the appropriate jurisdiction.**

## Acknowledgments

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## Chapter 1: Introduction to Cooperative Director Roles

Cooperative directors are responsible for decision-making and oversight for the business and affairs of their cooperative.<sup>1</sup> As cooperative directors know, decision-making and oversight are not small tasks. A director will be asked to review and monitor financials and risk, approve policies, evaluate leadership, monitor business activities, develop strategic plans, and more.<sup>2</sup> A director will be asked to do all of this in a way that meets their legal duties and forwards the cooperative's purpose.<sup>3</sup>

Cooperatives are owned and controlled by their users,<sup>4</sup> often referred to as members or member-owners. One of the main ways that members generally exercise control in their cooperative is the election of directors.<sup>5</sup> Typically, directors are elected *by* the members of their cooperative and *from* the members of the cooperative, meaning that cooperative directors have duties, obligations, and responsibilities as both a member and a director.<sup>6</sup>

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<sup>1</sup> JAMES BAARDA, U.S. DEP'T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 61, THE CIRCLE OF RESPONSIBILITIES FOR CO-OP BOARDS 3 (2014).

<sup>2</sup> *Id.* at 3-5.

<sup>3</sup> *Id.*

<sup>4</sup> DONALD A. FREDERICK, U.S. DEP'T OF AGRIC. RURAL DEV. COOPERATIVE INFORMATION REPORT 55, CO-OPS 101: AN INTRODUCTION TO COOPERATIVES 10 (James J. Wadsworth & E. Eldon Eversull eds., 2012).

<sup>5</sup> *Id.* at 10-11.

<sup>6</sup> BAARDA, *supra* note 1 at 4, 11.

Cooperatives are a unique type of business structure.<sup>7</sup> Often, they are legally referred to as cooperative corporations or cooperative associations under state law.<sup>8</sup> Cooperative directors often have legal duties under applicable cooperative laws and may also have similar or additional duties under applicable corporate laws.<sup>9</sup> Therefore, cooperative directors generally have similar legal responsibilities as directors of other types of corporations<sup>10</sup>, but cooperative directors face unique circumstances and challenges because of their dual role as both a member and a director.<sup>11</sup> There are also aspects of cooperative law that are unique and specific to cooperatives. In many ways, being a cooperative director can often be more challenging, with more complicated requirements, than being a director of a typical corporation.

### 1.1 Cooperative Director Rights and Responsibilities

In general, a cooperative's powers must be exercised by or under the authority of the board of directors pursuant to state law.<sup>12</sup> A cooperative is incorporated under state law<sup>13</sup> and a director should be familiar with the "act" under which their cooperative is established. The act is often referred to as the [State Name] Cooperative Association Act.

State law typically specifies that the business of a cooperative or corporation must be managed by or under the direction of the board of directors.<sup>14</sup> For example, according to the Ohio Cooperative Law, "all of the authority of an association shall be exercised by or under the direction of the board."<sup>15</sup> In addition to state law, a cooperative's articles of incorporation, bylaws, and internal policies form the foundation of the board's duties, obligations, responsibilities, and legal authority.<sup>16</sup>

The U.S. Department of Agriculture has conceptualized the role of a cooperative director as "seven circles of responsibility," including: representing cooperative members, establishing cooperative policies, hiring and supervising management, acquiring and preserving cooperative assets, preserving cooperative character, assessing the cooperative's performance, and informing members.<sup>17</sup> The Corporate Laws Committee of the American Bar Association conceptualized a corporate director's responsibility more succinctly – directors are responsible for decision-making and oversight.<sup>18</sup>

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<sup>7</sup> BAARDA, *supra* note 1 at 6.

<sup>8</sup> *Id.*; MICHAEL W. DROKE, DORSEY & WHITNEY LLP, COOPERATIVE BUSINESS LAW: A PRACTICAL GUIDE TO THE SPECIAL LAWS GOVERNING COOPERATIVES 1 (3d ed. 2020).

<sup>9</sup> BAARDA, *supra* note 1 at 6.

<sup>10</sup> DOUGLAS FEE, ALLEN C. HOBERG, & LINDA GRIM McCORMICK, U.S. DEP'T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 34, DIRECTOR LIABILITY IN AGRICULTURAL COOPERATIVES 1 (1996).

<sup>11</sup> BAARDA, *supra* note 1 at 11-12.

<sup>12</sup> CORPORATE LAWS COMMITTEE, AMERICAN BAR ASSOCIATION BUSINESS LAW SECTION, CORPORATE DIRECTOR'S GUIDEBOOK 12 (6<sup>th</sup> ed. 2011); BAARDA, *supra* note 1 at 3.

<sup>13</sup> DROKE, *supra* note 8 at 1.

<sup>14</sup> BAARDA, *supra* note 1 at 3.

<sup>15</sup> OHIO REV. CODE §1729.22(A) (West 2020).

<sup>16</sup> RURAL BUSINESS AND COOPERATIVE SERVICE, U.S. DEP'T OF AGRIC. RURAL DEV., COOPERATIVE INFORMATION REPORT 45 SECTION 9, UNDERSTANDING COOPERATIVES: LEGAL FOUNDATIONS OF A COOPERATIVE (1995).

<sup>17</sup> See BAARDA, *supra* note 1.

<sup>18</sup> CORPORATE LAWS COMMITTEE, *supra* note 12 at 11.

To fulfill their responsibilities, directors have legal and customary rights to access resources and information, which are often referred to as the cooperative's books and records, which includes financial information.<sup>19</sup> The directors also elect officers, meet regularly, set the meeting agenda, receive materials for meetings, review and approve board minutes, and request additional information as necessary to make informed decisions.<sup>20</sup> Additionally, directors generally have the right, within certain constraints, to access, hire or retain key executives and other employees, including legal counsel, experts, auditors and advisors, and to obtain information that is pertinent to meeting their legal duties.<sup>21</sup>

While this all may sound a bit overwhelming, in practical terms, one of the most important decisions a cooperative board of directors typically makes is the recruitment, selection, and review of the cooperative's chief executive officer or manager. A significant portion of a cooperative board's responsibility is delegated to the chief executive officer or general manager or additional officers, while the board retains oversight responsibility.<sup>22</sup>

One key factor to keep in mind is that a cooperative director does not have authority that is not provided to them. Outside of a properly called meeting where a quorum of directors is present, a director has no authority to act on behalf of the cooperative, unless specific tasks or authority has been delegated to them individually or to a committee or officer by board action, preferably in writing.<sup>23</sup>

Another key factor to keep in mind is that a cooperative board acts as a collective body,<sup>24</sup> but cooperative directors are required to exercise their judgment individually.<sup>25</sup> Directors are tasked with representing more than their local community, location, district or region. They are asked to make decisions based on what is in the best interest of the cooperative as a whole. A cooperative director is expected to honor the decision of the board of directors, if it was a lawful decision, even if they did not vote in agreement.

All of these legal duties encompass a director's responsibilities. This is an important point: a cooperative directors' decisions, actions or even inaction, can expose the board of directors, the members, the cooperative and, in some situations, the director to legal risk and liability.<sup>26</sup>

## 1.2 Sources of Potential Legal Risk

Cooperative directors owe legal duties to the cooperative itself, to cooperative members, and, in certain instances, to third parties, such as creditors or other contracted third

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<sup>19</sup> *Id.* at 17.

<sup>20</sup> *Id.* at 17; BAARDA, *supra* note 1.

<sup>21</sup> CORPORATE LAWS COMMITTEE, *supra* note 12 at 17.

<sup>22</sup> CORPORATE LAWS COMMITTEE, *supra* note 12 at 12; BAARDA, *supra* note 1 at 4.

<sup>23</sup> CORPORATE LAWS COMMITTEE, *supra* note 12 at 11; Email from Carolyn Eselgroth, Partner, Barrett, Easterday, Cunningham & Eselgroth, LLP, to author (Dec. 6, 2020) (on file with author).

<sup>24</sup> BAARDA, *supra* note 1 at 6; CORPORATE LAWS COMMITTEE, *supra* note 12 at 12.

<sup>25</sup> CORPORATE LAWS COMMITTEE, *supra* note 12 at 12.

<sup>26</sup> FEE ET AL., *supra* note 10 at 1; BAARDA, *supra* note 1 at 6-9.

parties.<sup>27</sup> When directors do not meet their legal duties, perhaps through wrongful acts or even through inaction where they have a duty to act, they expose the cooperative, and potentially themselves, to legal liability.<sup>28</sup> Liability can be criminal in nature and result in penalties such as fines or imprisonment,<sup>29</sup> or civil in nature, where the result is an order to pay monetary damages.<sup>30</sup> In some instances, courts can impose nonmonetary remedies, such as orders to do or to cease doing some action, this is often referred to as a court ordered injunction.<sup>31</sup>

Potential sources of legal action against cooperative directors include:

- cooperative members, or shareholders, through a direct lawsuit;<sup>32</sup>
- cooperative shareholders on behalf of the cooperative through a derivative suit;<sup>33</sup>
- third parties to whom the cooperative or director owes a legal obligation;<sup>34</sup>
- the cooperative itself in an action by the majority of other directors;<sup>35</sup> and
- local, state, or federal regulators for enforcement of laws and regulations, such as securities laws or workplace safety regulations.<sup>36</sup>

This guide is focused on legal risk, but the risks associated with directors' actions go beyond legal liability. Cooperative directors accused of wrongdoing may also face reputational consequences, including criticism from community members or other cooperative members. Where there has been inaction or wrongdoing by directors, the cooperative itself may lose business, face negative press, or suffer reputational harm in the community and among members.

### 1.3 Introduction to the Guide

The goal of this guide is to introduce directors of agricultural cooperatives to the legal duties arising from their board service.

Cooperative directors owe fiduciary duties to the cooperative itself, to the board of directors, and to members.<sup>37</sup> In addition to typical corporate duties as a director, cooperative directors have unique considerations when fulfilling their fiduciary duties,

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<sup>27</sup> FEE ET AL., *supra* note 10 at 1-3; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, PRACTICAL LAW PRACTICE NOTE OVERVIEW 6-382-1267, WESTLAW (2020).

<sup>28</sup> FEE ET AL., *supra* note 10 at 1-3; BAARDA, *supra* note 1 at 6.

<sup>29</sup> FEE ET AL., *supra* note 10 at 2, 10; CRIMINAL AND CIVIL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS, PRACTICAL LAW PRACTICE NOTE 6-501-9459, WESTLAW (2020).

<sup>30</sup> FEE ET AL., *supra* note 10 at 2.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.* Co-op shareholders can assert direct legal claims for harm to the shareholder – for example, to force payment of an obligated dividend or enforce other contractual rights. JOSEPH A. MCLAUGHLIN, SHAREHOLDER DERIVATIVE LITIGATION, PRACTICAL LAW PRACTICE NOTE 8-508-8277, WESTLAW (2020).

<sup>33</sup> FEE ET AL., *supra* note 10 at 2, 34. In a shareholder derivative lawsuit, a shareholder can bring a legal claim on behalf of a corporation against the directors or management of that corporation in an effort to remedy alleged misconduct that results in harm to all shareholders -- for example, claims that excessive executive compensation resulted in corporate waste. JOSEPH A. MCLAUGHLIN, SHAREHOLDER DERIVATIVE LITIGATION, PRACTICAL LAW PRACTICE NOTE 8-508-8277, WESTLAW (2020).

<sup>34</sup> FEE ET AL., *supra* note 10 at 1-3.

<sup>35</sup> *Id.*

<sup>36</sup> FEE ET AL., *supra* note 10 at 1-3; CRIMINAL AND CIVIL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS, *supra* note 29.

<sup>37</sup> See *infra* p. 11.

including the allocation and payment of patronage and the need to be aware of conflicts of interest created by being both a member and a director of the cooperative.<sup>38</sup> As the leaders of their cooperatives, directors can be held legally responsible for negligent actions or inactions that injure the cooperative, its members or third parties.<sup>39</sup> In *Chapter 2: Fiduciary Duties of Cooperative Directors*, readers will learn about the responsibilities that are encompassed within directors' fiduciary duties, including the duties of care and loyalty, in addition to the concepts of negligence and other business torts.

The cooperative business model creates a unique set of responsibilities for directors.<sup>40</sup> *Chapter 3: The "Cooperative Difference" in Director Responsibilities* will explore directors' responsibilities in relation to the distinctive characteristics of the cooperative model, from overseeing systems that ensure the cooperative's books and records are accurate, to decision-making about patronage refunds and equity redemption, to assessing opportunities and developing oversight systems that can involve antitrust laws.

Like all other businesses, cooperatives rely on both equity and debt to capitalize business operations.<sup>41</sup> Decisions about raising capital can be impacted by both state and federal laws that govern the initial sale of securities and regulate markets for securities, which are focused on protecting potential investors.<sup>42</sup> Because cooperative directors can be held liable for securities law violations,<sup>43</sup> it is important that they have a basic understanding of these laws. Directors can also be held responsible for their own wrongdoing in connection with their board responsibilities, and for the cooperative's violation of applicable laws.<sup>44</sup> *Chapter 4: Cooperatives, Securities and Other Laws* will provide an introduction to these areas of the law.

Cooperative directors may be protected from liability for certain actions.<sup>45</sup> A cooperative may indemnify its directors from liability for certain actions, and a cooperative may purchase directors and officers liability insurance.<sup>46</sup> While director's and officer's insurance may help cover certain costs, it does not protect against every potential risk.<sup>47</sup> These risk mitigation tools, and others, are introduced in *Chapter 5: Risk Management Tools for Cooperative Directors*.

The concepts discussed in this guide are often based in state law and are discussed generally. To fully understand their legal duties as applicable to their cooperative, directors should consult with their cooperative management, legal counsel, and other advisors specific to their cooperative.

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<sup>38</sup> BAARDA, *supra* note 1 at 11.

<sup>39</sup> FEE ET AL., *supra* note 10 at 6-12.

<sup>40</sup> See *infra* pp. 28-9.

<sup>41</sup> See *infra* p. 43.

<sup>42</sup> See *infra* pp. 44-5.

<sup>43</sup> See *infra* pp. 45-6.

<sup>44</sup> See *infra* pp. 48-9.

<sup>45</sup> See *infra* pp. 52-6.

<sup>46</sup> See *infra* pp. 54-6.

<sup>47</sup> See *infra* pp. 55-6.



Each chapter in this guide concludes with a director self-assessment. These are short checklists, questions, or topics for consideration to help directors apply these concepts to their own cooperative, identify areas for training, or note questions for their cooperative's management.

[Director Self-Assessment on Following Page.]

## 1.4 Director Self-Assessment

Cooperatives, like other business entities, are organized under state statutes,<sup>48</sup> so many of the concepts discussed in this guide will be based in law that varies from state to state. Additionally, the cooperative's articles of incorporation, bylaws, policy books, membership agreements, marketing agreements, and director handbook, form the legal foundation of the cooperative,<sup>49</sup> so it will be helpful for directors to review those items. Directors can get to know their cooperative better by reviewing the questions below. How well do you know your cooperative?

*What state is your cooperative incorporated in?*

*In what state(s) does your cooperative have physical locations? Conduct business? Have employees? Where are your customers and members located?*

*Are you familiar with your cooperative's articles of incorporation and bylaws? When were these documents last reviewed? Are they current? What questions do you have after reviewing these items?*

*What are the requirements to become a member of your cooperative? Is your membership list current?*

*Does your cooperative use membership agreements? Marketing agreements? Review the agreements and note questions for your cooperative's management team.*

*Have you reviewed your cooperative's director handbook and/or policy book? What questions do you have after reviewing these items?*

*Does your cooperative have an attorney on staff or work with an outside attorney? Do you know how to contact your cooperative's legal counsel?*

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<sup>48</sup> RURAL BUSINESS AND COOPERATIVE SERVICE, UNDERSTANDING COOPERATIVES: LEGAL FOUNDATIONS OF A COOPERATIVE, *supra* note 16 at 1.

<sup>49</sup> *Id.* at 1-4.



## Chapter 2: Fiduciary Duties of Cooperative Directors

Directors of boards, from agricultural cooperatives to community non-profits to traditional corporations, owe fiduciary duties to their cooperative, corporation, or organization. But what is a fiduciary duty? At the most basic, a fiduciary is “someone who is required to act for the benefit of another person on all matters within the scope of their relationship,”<sup>1</sup> while a duty is a “legal obligation that is owed or due to another..., that needs to be satisfied [or] that which one is bound to do, and for which somebody else has a corresponding right.”<sup>2</sup>

In a cooperative, directors owe the members, other directors, and the cooperative itself fiduciary duties, including a duty of loyalty and a duty of care.<sup>3</sup> A director’s failure to meet

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<sup>1</sup> *Fiduciary*, BLACK’S LAW DICTIONARY (11th ed. 2019).

<sup>2</sup> *Duty*, BLACK’S LAW DICTIONARY (11th ed. 2019).

<sup>3</sup> JAMES BAARDA, U.S. DEP’T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 61, THE CIRCLE OF RESPONSIBILITIES FOR CO-OP BOARDS 6-8 (2014); DOUGLAS FEE, ALLEN C. HOBERG, & LINDA GRIM MCCORMICK, U.S. DEP’T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 34, DIRECTOR LIABILITY IN AGRICULTURAL COOPERATIVES 3-6 (1996); Michael E. Traxinger, Corporate Attorney Agtegra Cooperative, Fiduciary Duties of the Board of Directors (April 26, 2018).

Note, “Directors only owe fiduciary duties to the preferred stockholders to the extent the preferred stockholders rely on a right they share with the common stockholders and not on their preferred rights and preferences which are contractual in nature and are governed by the terms of the certificate of designation under which the preferred stock was issued.” FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, PRACTICAL LAW PRACTICE NOTE OVERVIEW 6-382-1267, WESTLAW (2020). Additionally, directors may owe a duty of loyalty to the cooperative’s creditors in certain instances –

their fiduciary duties may result in liability for losses sustained by the directors, members or the cooperative itself.<sup>4</sup> Directors' fiduciary duties have well-developed legal meanings and form the foundation of directors' and officers' legal responsibilities as well as a guide in assessing their actions. This chapter will provide an overview of those duties and will offer considerations about the practical implications of these legal duties for agricultural cooperative directors.

The duties described in this chapter are typically founded in state law.<sup>5</sup> While fiduciary duties are common across states, there may be variations in state law that are relevant in specific situations. Reviewing the state statute under which their cooperative is incorporated and talking with their cooperative's counsel will help directors understand their specific duties under the law.

## 2.1 Duty of Care

A director's duty of care is often described in the state law under which their cooperative is incorporated or governed.<sup>6</sup> A cooperative may be organized under a law specific to cooperatives or under a law that applies to general corporations or both.<sup>7</sup> Under the Ohio Cooperative Law, "A director shall perform the duties of a director, including duties as a member of any committee of the directors upon which the director serves, in good faith, . . . *with the care that an ordinarily prudent person in a like position would use under similar circumstances.*"<sup>8</sup>

Generally, the duty of care requires that directors use care in their actions based on both subjective beliefs and objective standards.<sup>9</sup> As the *Corporate Director's Guidebook* from the American Bar Association Business Law Section described, the standard incorporates "the basic attributes of common sense, practical wisdom, and informed judgment generally associated with the position of corporate director."<sup>10</sup> As a publication for agricultural cooperative directors by the U.S. Department of Agriculture explained, the duty requires a director to utilize "independent judgment that is vigilant, skeptical, scrutinizing, and at all times honest and unbiased."<sup>11</sup>

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for example, if the corporation becomes insolvent. FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, PRACTICAL LAW PRACTICE NOTE OVERVIEW 6-382-1267, WESTLAW (2020).

<sup>4</sup> FEE ET AL., *supra* note 3 at 3-6; Traxinger, *supra* note 3.

<sup>5</sup> FEE ET AL., *supra* note 3 at 5; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>6</sup> FEE ET AL., *supra* note 3 at 5.

<sup>7</sup> MICHAEL W. DROKE, DORSEY & WHITNEY LLP, COOPERATIVE BUSINESS LAW: A PRACTICAL GUIDE TO THE SPECIAL LAWS GOVERNING COOPERATIVES 1 (3d ed. 2020); RURAL BUSINESS AND COOPERATIVE SERVICE, U.S. DEP'T OF AGRIC. RURAL DEV., COOPERATIVE INFORMATION REPORT 45 SECTION 9, UNDERSTANDING COOPERATIVES: LEGAL FOUNDATIONS OF A COOPERATIVE 1 (1995).

<sup>8</sup> OHIO REV. CODE §1729.23(A) (West 2020) (emphasis added). A co-op's articles of incorporation, under its organizing statute, may exculpate directors from breaches of their fiduciary duty of care, allowing the co-op to limit directors' personal liability for money damages for a breach of the duty of care, assuming breaches are not committed in bad faith or under a conflict of interest. Generally, these provisions cannot exculpate a director from their duty of loyalty. FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, PRACTICAL LAW PRACTICE NOTE OVERVIEW 6-382-1267, WESTLAW (2020). Exculpation provisions are discussed further in *Chapter 5: Risk Management Tools for Cooperative Directors*.

<sup>9</sup> CORPORATE LAWS COMMITTEE, AMERICAN BAR ASSOCIATION BUSINESS LAW SECTION, CORPORATE DIRECTOR'S GUIDEBOOK 19 (6<sup>th</sup> ed. 2011).

<sup>10</sup> *Id.*

<sup>11</sup> FEE ET AL., *supra* note 3 at 5.

In describing the duty of care, the publication *Cooperative Grocer* pointed to three main ways that cooperative directors can uphold their duty – showing up, being prepared, and protecting the board’s process.<sup>12</sup> First, cooperative directors exercise care in their board service by “showing up.”<sup>13</sup> Directors are expected to attend board meetings and other events where their presence is important or let the board leadership know in advance if they are unable to attend.<sup>14</sup> When directors do miss a meeting they are expected to carefully review the meeting materials, financials, and minutes to stay informed about the board’s actions.

Another way that directors can uphold their duty of care is by “being prepared” or by being aware of materials that are reasonably available to them when making decisions.<sup>15</sup> As a practical matter, the duty of care means that directors have a legal responsibility to be informed by preparing for meetings, thoroughly reviewing meeting materials,<sup>16</sup> and by reviewing the cooperative’s governing documents and other relevant information.<sup>17</sup>

As a part of their duty of care, cooperative directors may be held responsible for information they do not actually know if the information is something that the director *should have* known.<sup>18</sup> As one cooperative expert explained, “[a]s a general statement, directors will be charged with knowledge of *what it is their duty to know*.”<sup>19</sup> In one case, the Supreme Court of Delaware found that a corporate board had failed to reach an informed business decision as required by their duty of care when the board approved a plan to sell the corporation based primarily on the chairman and CEO’s representations without proper investigation into the company’s value.<sup>20</sup>

A third way directors can uphold their duty of care is by “protecting the board’s process.”<sup>21</sup> Directors can ensure the board has adequate information to make informed decisions and where they feel they do not “understand something well enough to act on it,” they would be well advised to seek additional information.<sup>22</sup> As discussed below, directors have a right to rely on certain parties as they make decisions, but this right does not remove a director’s independent judgment.<sup>23</sup> When a director is unsure, needs more information, or has a question, they would be well advised to ask and follow-through on their inquiry.

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<sup>12</sup> Thane Joyal & Dave Swanson, *Precautions and Protections: Summarizing legal responsibilities of cooperative boards*, *Cooperative Grocer* 28 (Mar. – Apr. 2011), [https://www.grocer.coop/system/files/legacy\\_files/precautions.pdf](https://www.grocer.coop/system/files/legacy_files/precautions.pdf).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> CORPORATE LAWS COMMITTEE, *supra* note 9 at 19-20; Joyal & Swanson, *supra* note 12 at 28.

<sup>16</sup> Joyal & Swanson, *supra* note 12 at 28.

<sup>17</sup> FEE ET AL., *supra* note 3 at 5; CORPORATE LAWS COMMITTEE, *supra* note 9 at 19-20.

<sup>18</sup> BAARDA, *supra* note 3 at 7.

<sup>19</sup> *Id.*

<sup>20</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del., 1985).

<sup>21</sup> Joyal & Swanson, *supra* note 12 at 28.

<sup>22</sup> *Id.*

<sup>23</sup> See *infra* p. 16.

The duty of care also requires directors who delegate responsibilities to officers or managers to prudently select and adequately supervise these individuals.<sup>24</sup> Directors are entitled to assume that cooperative officers and managers who are selected with reasonable care are acting appropriately, however, this assumption is not absolute.<sup>25</sup> When a board fails to ensure appropriate oversight, especially after being put on notice of a potential issue, they can expose the cooperative and themselves to liability.<sup>26</sup> Evaluating officer's and management's performance is not only important for the success of the cooperative, it is a part of the board's legal duties.<sup>27</sup>

This means that a directors' duty of care includes ensuring the cooperative has functional oversight and compliance systems.<sup>28</sup> As a part of this, cooperative directors have a responsibility to ensure the cooperative follows appropriate accounting standards to produce accurate financial records.<sup>29</sup>

If a cooperative's board of directors is not providing appropriate oversight, a party may successfully argue that a board "did so little to oversee a corporation's operations and exposure to risk that its failures amount to a conscious disregard of its duty to stay informed."<sup>30</sup>

For example, in 2019 the Delaware Supreme Court heard a lawsuit alleging that the corporate directors of Blue Bell breached their fiduciary duties because they failed to establish a board process or protocol for food safety oversight.<sup>31</sup> The lawsuit came after the death of customers who had consumed the company's ice cream following a listeria outbreak.<sup>32</sup> The court explained, if "a board has undertaken no efforts to make sure it is informed of a compliance issue intrinsically critical to the company's business operation" the board has not upheld their fiduciary duties.<sup>33</sup>

Directors are also responsible for ensuring that the cooperative files appropriate reports with certain state agencies where required.<sup>34</sup> For example, many states require cooperatives to submit annual reports about their business affairs.<sup>35</sup> Most cooperatives are also required, by state law or their organizing documents, to provide annual financial reports to their members and hold a member meeting at least once on an annual basis for the primary purposes of reviewing the current financials of the cooperative.<sup>36</sup> In some cases, directors have been charged for failure to file required reports and for filing false

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<sup>24</sup> FEE ET AL., *supra* note 3 at 5; BAARDA, *supra* note 3 at 7.

<sup>25</sup> FEE ET AL., *supra* note 3 at 17.

<sup>26</sup> *Id.*

<sup>27</sup> BAARDA, *supra* note 3 at 7.

<sup>28</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>29</sup> FEE ET AL., *supra* note 3 at 17.

<sup>30</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* quoting *Marchand v. Barnhill*, 212 A.3d 805, 822-23 (Del. 2019).

<sup>34</sup> FEE ET AL., *supra* note 3 at 15.

<sup>35</sup> *Id.*

<sup>36</sup> WORKING GROUP OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, NATIONAL COUNCIL OF FARMER COOPERATIVES, SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY 8 (2017); FEE ET AL., *supra* note 3 at 14.

reports when they have caused injury to others, such as creditors.<sup>37</sup> Whether a cooperative is required by law to provide annual reports to members is a state-specific question<sup>38</sup> and directors can check with their cooperative's counsel to ensure they are meeting their state's requirements in this area.

While a cooperative may not be required to provide annual reports to members, many states do require that the books and records of a cooperative are available to members for inspection.<sup>39</sup> For example, under Oklahoma's marketing cooperative statute, members may examine "at all reasonable times" the financial statement of the cooperative that shows the cooperative's assets and liabilities, earnings, purchases and sales, and expenses and outlays.<sup>40</sup> However, members' inspection rights are not completely open-ended.<sup>41</sup> Members, as shareholders, may be required to show "good cause" to be entitled to inspect the cooperative's books and records.<sup>42</sup>

Meeting minutes are one source of records generated by the cooperative's board of directors. Because corporate minutes are an official and permanent record of the entity,<sup>43</sup> it may be advisable for directors to consult with the cooperative's counsel in reviewing and approving minutes. A cooperative's counsel can provide more information about meeting record requirements, including whether minutes of committee meetings are required. Minutes serve multiple purposes and provide written documentation of a board's actions. When properly documented, minutes from meetings may provide supporting evidence about whether or not a board of directors met their duty of care, such as documenting the amount of consideration given to a potential business transaction or reviewing the audit.

### ***A Cautionary Tale: Ashby Farmers Cooperative Elevator Co.***

*In the fall of 2018, it became clear that something was awry at the Ashby Farmers Cooperative Elevator Co. in Ashby, Minnesota.<sup>44</sup> The cooperative's general manager of 30 years had skipped a cooperative meeting and left town<sup>45</sup> after an \$8 million line of credit came due without the assets to back it up<sup>46</sup>. Investigations revealed that over a 15-year period the manager had misused cooperative funds to pay for personal expenses including real estate, exotic hunting trips, home renovations, personal credit card charges,*

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<sup>37</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>38</sup> FEE ET AL., *supra* note 3 at 16.

<sup>39</sup> *Id.*

<sup>40</sup> OKLA. STAT. ANN. tit. 2, §17-13 (West 2020).

<sup>41</sup> FEE ET AL., *supra* note 3 at 16.

<sup>42</sup> *Id.*

<sup>43</sup> Minutes of the Board of Directors, Practical Law Standard Document 0-517-9375, WESTLAW (2020).

<sup>44</sup> Wyatt Bechtel, *Former Co-Op Manager Pleads Guilty to Charges for \$5.3 Million Fraud*, AgWeb (February 20, 2019), <https://www.agweb.com/article/former-co-op-manager-pleads-guilty-to-charges-for-53-million-fraud>.

<sup>45</sup> *Id.*

<sup>46</sup> Dan Browning, *Former Ashby grain elevator manager pleads guilty in \$5.3 million swindle*, Star Tribune (February 14, 2019), <https://www.startribune.com/former-ashby-grain-elevator-manager-pleads-guilty-in-5-3-million-swindle/505843082/?refresh=true>.

and more, to the tune of approximately \$5.3 million.<sup>47</sup> The cooperative consequently became insolvent, owing approximately \$10 million to creditors, and in early 2019 the manager was charged with tax evasion and mail fraud in federal court.<sup>48</sup>

Subsequently, the cooperative's creditors filed suit against former members of the cooperative board of directors for failure to uphold their fiduciary duties in managing and supervising the cooperative and the general manager.<sup>49</sup> The suit alleged that cooperative directors failed to investigate the manager's actions and to discover his wrongdoing, despite conspicuous expenditures such as multiple international hunting trips, "prodigious taxidermy," and "outrageous parties," that should have alerted directors that something was amiss.<sup>50</sup> A creditors' attorney claimed the "scheme was there in plain sight, and the directors did nothing."<sup>51</sup> In 2020, the suit against the cooperative's former directors was settled for \$1.45 million to be paid from the cooperative's directors' and officers' liability insurance.<sup>52</sup> The cooperative's assets are being liquidated in an effort to pay creditors who are expected to receive only a portion of what they are owed.<sup>53</sup>

**2.1.1 Relying on Certain Parties.** Directors of agricultural cooperatives bring unique and varied skills and experiences to their roles. However, cooperative directors are not experts in every matter they encounter during their board service. Directors have a right to rely on various experts they reasonably believe are competent including accountants, attorneys, cooperative officers, cooperative employees, and others -- assuming the directors have no knowledge to the contrary as to the experts' reports or information.<sup>54</sup> The right to rely on certain parties does not remove responsibilities from directors, it simply shows that directors exercised care in their decision making.<sup>55</sup> One key for cooperative directors is ensuring they have the right support from experts to assist the board in making informed and educated decisions.

## 2.2 Duty of Loyalty

The duty of loyalty requires that a director act in good faith for the benefit of the cooperative and cooperative members rather than in the director's own personal interest.<sup>56</sup> As with the duty of care, the duty of loyalty may be described in the state statute under which a cooperative is incorporated or governed. In Ohio, the duty requires that, "[a] director shall perform the duties of a director, including duties as a member of any committee of the directors upon which the director serves, *in good faith, in a manner the*

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<sup>47</sup> Mikkel Pates, *Ashby creditors settle for \$1.5 million from board insurance*, Duluth News Tribune (September 2, 2020) <https://www.duluthnewstribune.com/incoming/6644731-Ashby-creditors-settle-for-1.5M-from-board-insurance>).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> Mikkel Pates, *Elevator fraud victims likely to get a fraction of what is owed*, Grand Forks Herald (October 8, 2019) <https://www.grandforksherald.com/news/crime-and-courts/4707747-Elevator-fraud-victims-likely-to-get-a-fraction-of-what-is-owed>).

<sup>54</sup> FEE ET AL., *supra* note 3 at 5; CORPORATE LAWS COMMITTEE, *supra* note 9 at 20-21; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>55</sup> CORPORATE LAWS COMMITTEE, *supra* note 9 at 21.

<sup>56</sup> *Id.*



*director reasonably believes to be in or not opposed to the best interests of the association*  
...”<sup>57</sup>

The duty of loyalty for cooperative directors encompasses multiple responsibilities, including, generally, a duty to protect the interests of the cooperative and to abstain from conduct that would harm the cooperative.<sup>58</sup> This is the fiduciary duty that is most often litigated,<sup>59</sup> so it is important for directors to understand their responsibility of loyalty to the cooperative.

According to the duty of loyalty, directors must give their undivided loyalty to the cooperative.<sup>60</sup> This means directors must refrain from taking special advantages from the cooperative that are not available to the cooperative’s membership broadly<sup>61</sup> – this is known as “self-dealing.”<sup>62</sup> Because of their dual role as members and directors, cooperative directors will regularly do business with the cooperative as members, but issues with self-dealing arise when directors are treated preferentially in their business dealings with the cooperative compared to other members.<sup>63</sup> Additionally, directors should not prefer one group of cooperative members over another.<sup>64</sup>

When there is an opportunity for the cooperative, directors and their affiliates can only personally take advantage of the opportunity if the opportunity has first been rejected in good faith by the cooperative.<sup>65</sup> This is known as the “corporate opportunity doctrine.”<sup>66</sup> For example, if a cooperative has knowledge about the sale of a grain facility and shares confidential information about the sale with its directors and a director then uses that information for their own personal interest to purchase the grain facility themselves without the cooperative first passing on the opportunity, the director would be breaching their duty of loyalty to the cooperative.

Breaches of the duty of loyalty are reviewed by courts more stringently than breaches of the duty of care and directors do not benefit from either the business judgment rule or exculpation clauses under the duty of loyalty.<sup>67</sup> It is important for directors to understand the scope of their duty of loyalty and act diligently to ensure they uphold the duty.

**2.2.1 Conflicts of Interest.** Perhaps one of the stickiest points in a cooperative directors’ duty of loyalty is their duty to avoid using their position or the cooperative’s assets for personal gain, also known as a conflict of interest.<sup>68</sup> Generally, a conflict of interest is “a real or seeming incompatibility between one’s private interests and one’s public or fiduciary duties.”<sup>69</sup>

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<sup>57</sup> OHIO REV. CODE §1729.23(A) (West 2020) (emphasis added).

<sup>58</sup> CORPORATE LAWS COMMITTEE, *supra* note 9 at 23; FEE ET AL., *supra* note 3 at 4.

<sup>59</sup> FEE ET AL., *supra* note 3 at 4.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> BAARDA, *supra* note 3 at 8.

<sup>63</sup> *Id.*

<sup>64</sup> FEE ET AL., *supra* note 3 at 4.

<sup>65</sup> *Id.*

<sup>66</sup> CORPORATE LAWS COMMITTEE, *supra* note 9 at 26; FEE ET AL., *supra* note 3 at 4.

<sup>67</sup> CORPORATE LAWS COMMITTEE, *supra* note 9 at 28; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>68</sup> BAARDA, *supra* note 3 at 7.

<sup>69</sup> *Conflict of Interest*, BLACK’S LAW DICTIONARY (11th ed. 2019).

Service as a cooperative director may seem fraught with potential conflicts of interest because cooperative directors are themselves members and regular users of the cooperative.<sup>70</sup> Self-dealing, as discussed above, is a type of conflict of interest that can arise when a director takes special advantage of their position with the board in dealings with the cooperative. For example, when a director uses their position to receive a special deal unique to them on products purchased from the cooperative or a cooperative supplier, the director has engaged in self-dealing. Additionally, conflicts might arise where a director is involved with a competing business, including sitting on more than one cooperative or business board.<sup>71</sup>

While it is impossible to detail every situation where a conflict of interest might arise, one legal scholar pointed to the following as areas that could raise potential conflicts of interest in agricultural cooperatives: capitalization of the cooperative, payment of dividends, preferential treatment in insolvency, director compensation, and marketing and purchasing contracts.<sup>72</sup>

A cooperative director is expected to know enough about their cooperative to be able to know if there is a potential conflict. For example, does the cooperative have a unique supply agreement with a neighboring ethanol plant? Do any cooperative directors have an ownership interest in the ethanol plant or the company that owns the ethanol plant? If this conflict existed, it is likely not one that would prohibit an individual who has an ownership interest from serving as a cooperative director. Rather, it would likely only require the director to recuse themselves from acting on and/or discussing matters regarding the cooperative's unique supply agreement with the ethanol plant.

Other common examples of potential conflicts of interest for agricultural co-op directors include:

- being related to a cooperative employee;
- serving on another board that has transactions or a business arrangement with the cooperative, such as an electric cooperative, telecommunications cooperative, rural water board, city council, county commission, or township board; and
- owning stock or interests in a company that has a unique business relationship with the cooperative. A unique relationship is more than simply a transactional relationship of buying and selling from one party to the other. Generally, a unique relationship exists where there is some sort of contract between the parties that is unique to the two parties.

Cooperatives may have written conflict of interest policies for their directors and may even ask directors to sign an acknowledgement that they have read the policy when they join the board. The following is a short example of a cooperative conflict of interest policy from the U.S. Department of Agriculture:

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<sup>70</sup> BAARDA, *supra* note 3 at 7.

<sup>71</sup> FEE ET AL., *supra* note 3 at 4.

<sup>72</sup> Roger A. McEowen, What Is a Cooperative Director's Liability to Member-Shareholders and Others? Agricultural Law and Taxation Blog (July 19, 2017), <https://lawprofessors.typepad.com/agriculturallaw/2017/07/what-is-a-cooperative-directors-liability-to-member-shareholders-and-others.html>.

No director shall engage in any business or service activity that will place themselves in direct competition with any business unit or service offered by the Cooperative. If upon review of the board, any director is in the bounds of this conflict of interest policy, they shall be asked to resign. Failure to resign shall result in action as provided by the bylaws of the cooperative.<sup>73</sup>

A conflict of interest policy helps protect directors' duty of loyalty by preventing a director from serving as a cooperative director and as a director of a direct competitor of the cooperative. This would likely be considered an actual conflict and not just a potential conflict. It is important to note that not every potential conflict of interest is an actual conflict of interest.

Generally, a director is obligated to disclose conflicts of interest to the cooperative board.<sup>74</sup> A best practice for directors is to annually disclose potential conflicts of interest to the board of directors or the appropriate board committee, along with the chief executive officer or general manager and cooperative's legal counsel. If a director is unsure if there is a conflict, the easiest thing to do is to simply disclose the information to the board and/or recuse themselves from the portion of the meeting that involves the potential conflict. It is also important that the board minutes reflect when a director discloses a potential or actual conflict of interest and if the director recused themselves. Including this information with the board's minutes provides an official record if the director or the cooperative is ever challenged on a particular conflict.

### **2.3 Additional Duties**

The duty of care and the duty of loyalty are the primary fiduciary duties for corporate directors, although additional obligations are encompassed within these two duties.<sup>75</sup> These include, but are not limited to, the duty of good faith, confidentiality, candor and obedience.

**2.3.1 Good Faith.** Both the duty of loyalty and the duty of care require that a director act in good faith.<sup>76</sup> A director who acts in good faith acts "with honesty of purpose and in the best interest of the [cooperative]."<sup>77</sup> While good faith and bad faith may be difficult to define exactly, several common-sense circumstances point toward bad faith.<sup>78</sup> Bad faith can include: a cooperative director intentionally failing to act in a situation where there is a known duty to act, indicating a conscious disregard for one's duties; a knowing violation of the law; and acting for any purpose other than advancing the best interests of the cooperative or its members.<sup>79</sup>

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<sup>73</sup> GALEN RAPP, U.S. DEP'T OF AGRIC. AGRIC. COOP. SERV. COOPERATIVE INFORMATION REPORT 39, SAMPLE POLICIES FOR COOPERATIVES 9 (1993).

<sup>74</sup> FEE ET AL., *supra* note 3 at 4; McEowen, *supra* note 72.

<sup>75</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

Good faith requires that a director act toward the cooperative in a way that is fair and intended to benefit the cooperative, including avoiding fraud, misappropriation of assets, sale of board influence, and other improper actions.<sup>80</sup> Some cooperatives may require their directors to acknowledge and abide by a written code of ethics to help provide directors with guidance and direction.<sup>81</sup>

**2.3.2 Confidentiality and Candor.** The duty of confidentiality is a part of the broader duty of loyalty.<sup>82</sup> Directors have a duty to keep non-public information about the cooperative confidential. Many cooperatives reference a director's duty of confidentiality in their governing documents, and some have adopted confidentiality policies or require directors to sign a confidentiality agreement.<sup>83</sup>

Discussing confidential information outside of the boardroom can create a host of potential issues and risks, including liability or reputational issues, even if a director inadvertently discloses information that they were expected to keep confidential.<sup>84</sup> If a director is unsure if information is confidential, they should ask cooperative management or simply err on the side of the information being confidential.

It may be helpful for directors to have a prepared response for inquiries from cooperative members or community members indicating that information is confidential and not something they are able to discuss. An attorney writing on the topic shared the following areas where caution by directors is especially prudent: sharing information that could jeopardize the cooperative or place it at a competitive disadvantage; personnel matters; real estate acquisitions; business acquisitions or partnerships; lease negotiations; and litigation.<sup>85</sup>

A very short example of a cooperative confidentiality policy from the U.S. Department of Agriculture states:

A director may not disclose information obtained by virtue of his or her position as director before such information is made available to all members at the direction of the board, nor provide such information to selected persons under circumstances giving business or other advantage to the director or other persons.<sup>86</sup>

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<sup>80</sup> FEE ET AL., *supra* note 3 at 4.

<sup>81</sup> DROKE *supra* note 7 at 65.

<sup>82</sup> BAARDA, *supra* note 3 at 8.

<sup>83</sup> DROKE *supra* note 7 at 65.

<sup>84</sup> *Id.* at 67.

<sup>85</sup> *Id.* at 65.

<sup>86</sup> RAPP *supra* note 73 at 10.

### **CEO Perspective: Confidentiality**

*When it comes to confidentiality and cooperative boards, former CEO of United Producers, Inc. (UPI), a livestock marketing cooperative serving over 35,000 members in the midwestern United States,<sup>87</sup> Dennis Bolling shared that “attention to confidentiality can’t stifle doing business, but lack of confidentiality shouldn’t increase business risk.” In particular, as many cooperatives implement complex legal strategies, such as mergers, acquisitions, or bankruptcy proceedings, confidentiality becomes extremely important, particularly as situations are fluid and communications will be shared with various cooperative stakeholders. In a cooperative, the duty of confidentiality can be challenging because directors often feel that members have a “right to know” information. Bolling often reminds cooperative directors that in some ways, members elected directors to the board “to know” on their behalf.<sup>88</sup>*

Directors may also have a duty to communicate honestly with members.<sup>89</sup> Sometimes this duty is called the duty of candor or honesty and to the extent permitted, it requires that disclosures to members are full and fair.<sup>90</sup> However, this is not a requirement for directors to disclose all of the cooperative’s information. It is also not permission for a director to breach their duty of confidentiality to the cooperative. Information that is privileged or confidential is expected to be kept privileged and confidential.<sup>91</sup>

**2.3.3 Obedience.** Directors have a duty to comply with laws as they act on behalf of the cooperative.<sup>92</sup> A director does not have to know every detailed legal requirement for a cooperative, but they do have a duty to know which laws are applicable and when to seek legal counsel.

Cooperative directors are expected to be generally familiar with which laws may apply to their cooperative. There are federal laws and regulations that will likely apply to the cooperative, which may include the Capper-Volstead Act, along with state and local laws and regulations determined by where the cooperative conducts business.

It is also advisable for cooperative directors to be familiar with what they can and cannot do based on a cooperative’s governing law(s), articles of incorporation, bylaws, policies, and contracts.<sup>93</sup> Directors act within the powers granted by these sources and an action outside of what is authorized by these sources is called an ‘ultra vires act.’<sup>94</sup>

For example, a cooperative’s articles of incorporation or bylaws typically include an article or section that specifies the cooperative’s purpose. A cooperative engaging in a line of

<sup>87</sup> ABOUT UPI, United Producers, Inc. <https://www.uproducers.com/about-upi/> (last visited Jan. 7, 2021).

<sup>88</sup> Interview with Dennis Bolling, Former CEO, United Producers, Inc. (Sept. 28, 2020).

<sup>89</sup> CORPORATE LAWS COMMITTEE, *supra* note 9 at 28.

<sup>90</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>91</sup> *Id.*

<sup>92</sup> FEE ET AL., *supra* note 3 at 6; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3; BAARDA, *supra* note 3 at 7.

<sup>93</sup> FEE ET AL., *supra* note 3 at 6.

<sup>94</sup> FEE ET AL., *supra* note 3 at 6; BAARDA, *supra* note 3 at 7.

business that is not included in the cooperative's purpose would be an ultra vires act. Cooperative directors have been deemed to be acting ultra vires when engaging in a line of business not authorized by the articles of incorporation or bylaws, publishing libel, and engaging in secret, speculative grain trading.<sup>95</sup>

The South Dakota Cooperative Association Act prohibits cooperatives from being organized for the purpose of banking and insurance.<sup>96</sup> Some states, such as Wyoming, Wisconsin, and Utah, state in their cooperative or corporate statutes that an association may be dissolved if it exceeds the authority conveyed to it by state statute.<sup>97</sup> Directors who are familiar with the limitations applicable to their cooperative, if any, are in a better position to fulfill their legal duties.

Directors can be held personally liable for ultra vires acts.<sup>98</sup> However, if the cooperative membership appropriately approves an ultra vires act prior to or following its occurrence, the director may not be held personally liable.<sup>99</sup> In other words, if the purpose of the cooperative is amended, in accordance with applicable law, to permit the new line of business, it would not be considered an ultra vires act.

## 2.4 Negligence, Fraud and Other Business Torts

Many people have heard the term “negligence,” whether in popular culture or in their business dealings. What is negligence from a legal perspective? Generally, “[a] party acts negligently when it fails to exercise the degree of care that a reasonably prudent person would have used under similar circumstances.”<sup>100</sup> A director who has acted negligently has breached their general duty of care.<sup>101</sup>

When a cooperative director acts negligently and harms a party to whom they owe a fiduciary duty, the director can be liable for both negligence and breach of their fiduciary duty.<sup>102</sup> A director's negligence may also harm a party to whom they owe no fiduciary duty and the director may be liable for negligence, but not for breach of a fiduciary duty.<sup>103</sup> When a party is liable for negligence, they are often required to pay damages to the injured party.<sup>104</sup>

Whether a director was negligent in their actions is a question that depends on the facts and circumstances of each situation.<sup>105</sup> While the specifics may vary, generally, to prove negligence a party must show that the accused party owed a duty to the party bringing

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<sup>95</sup> FEE ET AL., *supra* note 3 at 6.

<sup>96</sup> S.D. CODIFIED LAWS §47-15-2 (West 2020).

<sup>97</sup> WYO. STAT. ANN. §17-10-247 (West 2020); WIS. STAT. ANN. §185.92 (West 2020); UTAH CODE ANN. §3-1-20.1 (West 2020).

<sup>98</sup> FEE ET AL., *supra* note 3 at 6.

<sup>99</sup> *Id.*

<sup>100</sup> NEGLIGENCE, GROSS NEGLIGENCE, AND WILLFUL MISCONDUCT, Practical Law Practice Note 5-524-2421, WestLaw (2020).

<sup>101</sup> See *supra* p. 12.

<sup>102</sup> FEE ET AL., *supra* note 3, at 7.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* In some instances, a co-op or its director's and officer's insurance (“D&O insurance”) may pay for or reimburse damages owed by directors; these tools are discussed in *Chapter 5: Risk Management Tools for Co-op Directors*.

<sup>105</sup> *Id.*

allegations and failed to act with the standard of care required to uphold their duty.<sup>106</sup> The party alleging negligence must also show that this failure caused them actual damage or loss.<sup>107</sup>

A guide on cooperative director liability from the U.S. Department of Agriculture identified the following “areas of conduct” where a director owes a duty that could lead to claims of negligence:

- selection and supervision of employees and officers;
- safeguarding the cooperative’s assets;
- oversight of the cooperative’s management;
- failure to make accurate statements in registering securities; and
- failure to investigate “known questionable character and activities of agents and proposed transactions.”<sup>108</sup>

### ***Avoiding Allegations of Negligence: Taking Care in Leading the Cooperative***

*While there is no “silver bullet” to ensure cooperative directors are never accused of negligence, a U.S. Department of Agriculture guide, “Director Liability in Agricultural Cooperatives,” recommends, “Above all, a director is advised to insure against suits for negligence by at least attending all or almost all board meetings, asking questions about reports and representations, having any dissent reported in the minutes, and seeking advice of counsel when in doubt.”<sup>109</sup>*

**2.4.1 Fraud and Other Business Torts.** In legal terms, negligence is known as a “tort.” A tort is “a breach of a duty that the law imposes on persons who stand in a particular relation to one another.”<sup>110</sup> In addition to negligence, there are various torts in the business context. A business tort is one that “result[s] in injury to a plaintiff’s business or business interests, to an economic interest, or to the plaintiff’s contracts with third person.”<sup>111</sup> Depending on the circumstances, the legal remedy imposed on a party who has committed a tort might be monetary damages or other remedies such as the rescission of a contract.<sup>112</sup> Consulting with an attorney can be very helpful for cooperative directors to better understand their potential liabilities related to fraud and other applicable business torts.

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<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 7-8.

<sup>109</sup> FEE ET AL., *supra* note 3, at 9.

<sup>110</sup> *Tort*, Black’s Law Dictionary (11<sup>th</sup> ed. 2019).

<sup>111</sup> 9 STUART M. SPEISER, CHARLES F. KRAUSE, & ALFRED W. GANS, AMERICAN LAW OF TORTS § 31:1 (Monique C. M. Leahy eds. 2020).

<sup>112</sup> 10 STUART M. SPEISER, CHARLES F. KRAUSE, & ALFRED W. GANS, AMERICAN LAW OF TORTS § 32:5 (Monique C. M. Leahy eds. 2020).

**2.4.2 Fraud and Misrepresentation.** Cooperative directors can be liable for fraud or misrepresentation to the cooperative and to third parties.<sup>113</sup> Fraud is a term that encompasses a wide variety of dishonest behaviors.<sup>114</sup>

Generally, the legal elements of fraud require:

1. a “false representation of a material fact;”
2. the party making the representation knew it was false;
3. the representation was made to induce another party to act upon it;
4. the relying party justifiably relied on the representation; and
5. the relying party was harmed as a result.<sup>115</sup>

In some instances, an affirmative act may not be required for a behavior to constitute fraud.<sup>116</sup> Rather, omissions and concealments that involve the breach of a duty, trust, or confidence can also constitute fraud.<sup>117</sup>

While fraud generally requires an intent to deceive, a legal cause of action for negligent misrepresentation has no such requirement.<sup>118</sup> Rather, negligent misrepresentation refers to “a careless or inadvertent false statement in circumstances where care should have been taken.”<sup>119</sup>

Examples of conduct that could lead to an allegation of fraud or misrepresentation by a cooperative director include:

- writing checks against insufficient funds;
- refusing to return funds that were fraudulently obtained; and
- misrepresentations to creditors.<sup>120</sup>

A director may not be committing fraud themselves, but they could be negligent if they fail to put policies in place to prevent fraud by others in the cooperative.

**2.4.3 Tortious Interference with Contractual Relationships.** Knowing the cooperative’s business and key contractual relationships is important for a director to meet their fiduciary duties. Tortious interference with contractual relationships is “[a] third party’s intentional inducement of a contracting party to break a contract, causing damage to the relationship between contracting parties.”<sup>121</sup>

Although the specifics vary among states, the elements of a claim for tortious interference with contractual relationships include:

- “1. the existence of a contract with a third party;

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<sup>113</sup> FEE ET AL., *supra* note 3, at 9.

<sup>114</sup> STUART ET AL, *supra* note 112 at § 32:4.

<sup>115</sup> STUART ET AL, *supra* note 112 at § 32:4; MATTHEW A. CARTWRIGHT, KIRK REASONOVER, JOSEPH C. PFEIFFER, *LITIGATING BUSINESS AND COMMERCIAL TORT CASES* § 3:2 (2020).

<sup>116</sup> STUART ET AL, *supra* note 112 at § 32:4.

<sup>117</sup> *Id.*

<sup>118</sup> CARTWRIGHT, *supra* note 115 § 3:1.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *Tortious interference with contractual relationships*, Black’s Law Dictionary (11<sup>th</sup> ed. 2019).



2. the defendant's knowledge of that contract;
3. the defendant's intentional act of interfering with, disrupting, or inducing the breach of, that contract; and
4. resulting damages."<sup>122</sup>

The instances where such a claim can arise are varied. For example, when a company hires a new employee whose employment violates a confidentiality agreement, a non-compete agreement, or non-solicitation agreement with a former employer, the former employer may claim tortious interference against the new employer alleging that the new employer induced, encouraged, or assisted the employee's breach.<sup>123</sup>

**2.4.4 Trade Disparagement or Trade Defamation.** In general, where a party makes false and defamatory statements about a business with the intent to cause harm to that business, and is successful in causing harm, they may be liable for business defamation.<sup>124</sup> This cause of action may be called trade defamation, commercial defamation, trade disparagement, product disparagement, or other terms.<sup>125</sup>

For example, in response to news reports about "lean finely textured beef," called "pink slime" in news reporting, the South Dakota company Beef Products, Inc., alleged defamation against the news network ABC.<sup>126</sup> Beef Products, Inc. alleged that ABC's reports were misleading regarding the product's safety and that public backlash to the reports led to substantial sales decreases, the closure of a plant, and the layoff of about 300 workers.<sup>127</sup> ABC and Beef Products, Inc. settled the lawsuit in 2017.<sup>128</sup>

By no means are the torts discussed above the only ones that a cooperative director might confront during their board service. For example, directors may be accused of conversion, or "serious interference with another's personal property," or nuisance, the "ordering or consenting to the creation or maintenance of a nuisance."<sup>129</sup> To help avoid allegations of tortious conduct, it is important that cooperative directors conduct themselves according to high standards of ethical behavior and consult knowledgeable, trusted advisors when they have questions or concerns. Some cooperatives have adopted policies on ethics for directors, management and employees to help protect the cooperative.

**2.4.5 The Business Judgment Rule.** As many directors can surely attest, making decisions for a cooperative is a complex matter. While they are legally required to exercise care in their actions under the duty of care, directors are not required to guarantee the success of their actions or decisions. When determining if there has been a breach of

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<sup>122</sup> CARTWRIGHT, *supra* note 115 at § 2:1.

<sup>123</sup> Robert D. Goldstein & Peter A. Steinmeyer, *Hiring from a Competitor: Practical Tips to Minimize Litigation Risk*, Practical Law Practice Note 6-566-2609, Westlaw (2020).

<sup>124</sup> CARTWRIGHT, *supra* note 115 at §§ 10:1-2.

<sup>125</sup> CARTWRIGHT, *supra* note 115 at § 10:1.

<sup>126</sup> Daniel Victor, *ABC Settles With Meat Producer in 'Pink Slime' Defamation Case*, The New York Times (June 28, 2017) <https://www.nytimes.com/2017/06/28/business/media/pink-slime-abc-lawsuit-settlement.html>.

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> FEE ET AL., *supra* note 3, at 10.

fiduciary duties, courts are generally hesitant to substitute their own judgment for the judgment of corporate directors,<sup>130</sup> assuming the decision “was the product of a process that was *either* deliberately considered in good faith or was otherwise rational.”<sup>131</sup> A court presumes directors met their duty of care in situations where directors met the following conditions: (i) directors met their duty to inform themselves of material information reasonably available to them prior to making a business decision; (ii) directors acted in good faith through a process that was substantive, (iii) and directors reasonably believed the action was in the best interest of the business.<sup>132</sup> This presumption is known as the “business judgment rule” and it is generally considered the standard to determine if a director met their legal duties and can be protective of directors.<sup>133</sup>

It is important to note that the business judgment rule is not an impenetrable shield for directors. In cases where directors abused their discretion, acted in bad faith, or intentionally disregarded a conflict of interest, the business judgment rule will not help directors escape liability.<sup>134</sup> Additionally, even in a situation where cooperative directors have met their duties to stay informed, acted in good faith, and acted in the best interest of the cooperative, directors can still be held liable for unconscionable cases of irrationally wasting the cooperative’s assets, although the standard for recovering under a claim like this is considered stringent.<sup>135</sup>

## 2.5 Conclusion

A cooperative director’s fiduciary duties form the foundation of their legal duties. The duty of care and duty of loyalty, in addition to ancillary duties such as good faith and obedience, inform the ways that directors approach their leadership role with the cooperative. In addition to fiduciary duties, tort law places certain standards on the behavior of directors as they act on behalf of their cooperative. To avoid claims of negligence and other tortious conduct, directors are expected to approach their board service with prudence. Cooperative directors are not legally required to make perfect decisions, but they are expected to act with care, to stay informed, to avoid conflicts of interest, to act in good faith and to maintain confidential information. Cooperative directors are expected to act within the law and the powers granted by the cooperative’s governing documents.

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<sup>130</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

<sup>131</sup> In re Walt Disney Co. Derivative Litigation, 907 A.2d 693, 749 (Del.Ch., 2005).

<sup>132</sup> CORPORATE LAWS COMMITTEE, *supra* note 9 at 27; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3; FEE ET AL., *supra* note 3 at 5-6; BAARDA, *supra* note 3 at 8.

<sup>133</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3; In re Walt Disney Co. Derivative Litigation, 907 A.2d at 749.

<sup>134</sup> BAARDA, *supra* note 3 at 8.

<sup>135</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 3.

## 2.6 Director Self-Assessment

It is important for directors to understand and act within their fiduciary duties to avoid legal liability. The following checklist can help directors understand the practical implications of their fiduciary duties and identify their strengths and areas for improvement.

	Yes	No
<i>I have read the cooperative's articles of incorporation, bylaws, board handbook, and policies and asked questions where items were unclear.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I regularly attend board and committee meetings and notify board leaders when I will miss a meeting.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I thoroughly review materials provided to me prior to board meetings, including past meeting minutes and financial or compliance reports.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I approach the cooperative's legal counsel, key advisors, or management when I feel I need additional information to make an informed decision.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I participate and understand the board's process for selecting and reviewing the performance of cooperative officers, including the CEO or general manager.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I am generally aware of the cooperative's oversight and compliance systems. The board is involved with these processes or regularly receives reports from management on oversight and compliance.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I have reviewed the cooperative's conflict of interest policy and have identified items that could present a potential conflict for me, including engagement with other businesses or service on other boards.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I have reviewed the cooperative's code of ethics for directors.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I understand the board's process for disclosing a potential conflict of interest when it arises and am comfortable making a disclosure and recusing myself from decision-making when needed.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I understand that as a director I may not take special advantage of my role in my dealings with the cooperative.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I have reviewed the cooperative's confidentiality policy for directors.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I am comfortable asking questions or raising potential issues to my fellow directors or to the cooperative's management team.</i>	<input type="checkbox"/>	<input type="checkbox"/>



## Chapter 3: The “Cooperative Difference” in Director Duties

Cooperatives are member-owned, member-controlled, and for the benefit of the member(s).<sup>1</sup> Members are the legal owners of the business and have rights to the business’s assets.<sup>2</sup> Members direct the business through their right to elect the board of directors and vote on major issues.<sup>3</sup> A cooperative functions to serve the needs of members rather than to maximize profit in the same ways as other corporate structures.<sup>4</sup>

These distinctive characteristics are the primary differences that make the cooperative model unique and make a director’s legal duties more complex than those of directors in other corporate forms. They also impact the ways that cooperatives typically function – cooperatives are often financed, in part, by member investments with members receiving equity and sharing in profits.<sup>5</sup> Members often have a strong say in the governance of the cooperative through member meetings and election of directors, and cooperatives generally have a special focus on building and maintaining relationships with members.<sup>6</sup>

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**The information contained in this document is provided for educational purposes only. It is not legal advice and is not a substitute for the potential need to consult with a competent attorney licensed to practice law in the appropriate jurisdiction.**

<sup>1</sup> DONALD A. FREDERICK, U.S. DEP’T OF AGRIC. RURAL DEV. COOPERATIVE INFORMATION REPORT 55, CO-OPS 101: AN INTRODUCTION TO COOPERATIVES 9-13 (James J. Wadsworth & E. Eldon Eversull eds., 2012).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> FREDERICK, *supra* note 1 at 9; MICHAEL W. DROKE, DORSEY & WHITNEY LLP, COOPERATIVE BUSINESS LAW: A PRACTICAL GUIDE TO THE SPECIAL LAWS GOVERNING COOPERATIVES 3 (3d ed. 2020).

<sup>5</sup> FREDERICK, *supra* note 1 at 9-13.

<sup>6</sup> FREDERICK, *supra* note 1 at 9-13.

The cooperative model is informed by a set of internationally recognized principles.<sup>7</sup> These principles, and the unique aspects of the model, help inform directors' leadership.<sup>8</sup> This chapter will explore directors' legal duties related to the distinctive characteristics of cooperatives. Generally, lawsuits that involve these concepts are brought against the cooperative, although it is possible for directors to be personally responsible for actions or inactions under these concepts.<sup>9</sup>

## **Cooperative Principles**

*The International Cooperative Alliance (ICA), which “unites, represents and serves cooperatives” globally, has memorialized the modern cooperative principles as:*

### **P1: Voluntary and Open Membership**

*“Cooperatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination.”*

### **P2: Democratic Member Control**

*“Cooperatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions...”*

### **P3: Member Economic Participation**

*“Members contribute equitably to, and democratically control, the capital of their cooperative...”*

### **P4: Autonomy and Independence**

*“Cooperatives are autonomous, self-help organisations controlled by their members...”*

### **P5: Education, Training, and Information**

*“Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives...”*

### **P6: Cooperation Among Cooperatives**

*“Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.”*

### **P7: Concern for Community**

*“Cooperatives work for the sustainable development of their communities through policies approved by their members.”<sup>10</sup>*

<sup>7</sup> *Cooperative identity, values & principles*, INTERNATIONAL COOPERATIVE ALLIANCE

<https://www.ica.coop/en/cooperatives/cooperative-identity> (last visited Nov. 21, 2020).

<sup>8</sup> JAMES BAARDA, U.S. DEP'T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 61, THE CIRCLE OF RESPONSIBILITIES FOR CO-OP BOARDS 4-5 (2014).

<sup>9</sup> DOUGLAS FEE, ALLEN C. HOBERG, & LINDA GRIM MCCORMICK, U.S. DEP'T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 34, DIRECTOR LIABILITY IN AGRICULTURAL COOPERATIVES 14 (1996).

<sup>10</sup> International Cooperative Alliance, INTERNATIONAL COOPERATIVE ALLIANCE <https://www.ica.coop/en/about-us/international-cooperative-alliance> (last visited Jan. 3, 2021); *Cooperative identity, values & principles*, *supra* note 6. Readers interested in learning more about the history, development, and practical application of the cooperative principles as outlined by the ICA can explore the organization's [Guidance Notes to the Cooperative Principles](#).

### 3.1 Formation of Cooperatives

Cooperatives can be set up in a variety of ways. A cooperative is typically financed by members, stockholders, capital from lenders or a combination of one or more of these options.<sup>11</sup> Cooperatives can be set up with stock or without stock.<sup>12</sup> They can have different types of stock<sup>13</sup> and different requirements to qualify to be a member<sup>14</sup>.

To fully understand their legal responsibilities, it is important for a cooperative director to understand how their cooperative is financed and structured, including the answers to the following questions:

- What are the cooperative's requirements for membership?
- Is the cooperative a stock cooperative? If yes, what type of stock does the cooperative offer? Are there multiple classes of stock?
- Who are the equity holders or shareholders of the cooperative?
- Who is eligible to receive patronage from the cooperative?

An agricultural cooperative may also attempt to meet the requirements of the Capper-Volstead Act to obtain limited exemptions to federal antitrust laws.<sup>15</sup> A Capper-Volstead cooperative's members must be agricultural producers, as defined under the law.<sup>16</sup>

### 3.2 Protecting the Cooperative's Financial Health

One of the main responsibilities of cooperative directors is acquiring and preserving cooperative assets.<sup>17</sup> As the U.S. Department of Agriculture explained, "The assets of a cooperative were purchased with member money, and the cooperative is obligated to those members."<sup>18</sup> Various laws and duties place responsibility on cooperative directors for ensuring that the cooperative does not unnecessarily or inappropriately deplete its capital.<sup>19</sup> According to the U.S. Department of Agriculture, some state statutes place additional requirements on a cooperative's ability to take on debt.<sup>20</sup> A Wyoming statute makes cooperative directors personally liable for debts the cooperative takes on in excess of available assets or stock:

If the indebtedness of such corporation shall at any time exceed the amount of the assets of a nonstock corporation or the amount of subscribed capital stock of a stock company, the directors assenting thereto shall be personally and individually liable for such excess to the creditors.<sup>21</sup>

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<sup>11</sup> RURAL BUSINESS AND COOPERATIVE SERVICE, U.S. DEP'T OF AGRIC. RURAL DEV., COOPERATIVE INFORMATION REPORT 45 SECTION 7, UNDERSTANDING COOPERATIVES: FINANCING COOPERATIVES (1994).

<sup>12</sup> See *infra* p. 31-2.

<sup>13</sup> *Id.*

<sup>14</sup> RURAL BUSINESS AND COOPERATIVE SERVICE, U.S. DEP'T OF AGRIC. RURAL DEV., COOPERATIVE INFORMATION REPORT 45 SECTION 4, UNDERSTANDING COOPERATIVES: WHO RUNS THE COOPERATIVE BUSINESS? MEMBERS (2011).

<sup>15</sup> See *infra* pp. 37-41.

<sup>16</sup> *Id.*

<sup>17</sup> BAARDA, *supra* note 8 at 4.

<sup>18</sup> *Id.*

<sup>19</sup> FEE ET AL., *supra* note 9 at 19-21.

<sup>20</sup> FEE ET AL., *supra* note 9 at 20.

<sup>21</sup> WYO. STAT. ANN. §17-10-114 (West 2020).

Directors have a right to access information required to fulfill their duties<sup>22</sup> and directors ought to receive financial information on a regular basis. Annual audits of a cooperative's finances, and other key areas of compliance or risk, assists directors in meeting their responsibilities.<sup>23</sup> If directors do not have enough information to be informed or make educated decisions, they are likely not meeting their obligations. In addition to reviewing financial information and audits, the board of directors can develop policies that assist them in meeting their obligations.<sup>24</sup> Board policies are often useful to prevent fraud and abuse of a cooperative's finances. The board can set parameters for management on the approval of expenditures and issuing of payments. A cooperative's auditor can often provide recommendations to the board on best practices, policies, and procedures to put into place to assist the board in meeting their duties.

### 3.3 Cooperative Stock

Some cooperatives are organized as stock cooperatives and others are organized as nonstock cooperatives.<sup>25</sup> Generally, the primary difference between a stock cooperative and a nonstock cooperative is that in a stock cooperative an individual or entity must own stock to be a member.<sup>26</sup> In a stock cooperative, members purchase stock to receive membership and/or voting rights.<sup>27</sup> This stock is generally referred to as common stock.<sup>28</sup> There can be more than one class of common stock to differentiate between types of members or even member and non-member stockholders, among various other uses.<sup>29</sup>

Even if a cooperative is not a stock cooperative, it can generally still issue stock. Often times this is referred to as preferred stock, which may be issued to members and non-members alike, depending upon applicable securities laws.<sup>30</sup>

Both common stock and preferred stock can confer various rights to stockholders, such as rights to dividends and preferences upon a cooperative's liquidation.<sup>31</sup> As discussed, member ownership, control, and benefit, are central to the cooperative model and to uphold these concepts, state laws, cooperative articles of incorporation, and cooperative bylaws can limit the dividends and interest that is payable on cooperative stock.<sup>32</sup> According to the U.S. Department of Agriculture, most states limit the interest and dividends that a cooperative can pay to common and preferred stockholders.<sup>33</sup> Additionally, state statutes may set specific requirements for making changes to the dividend rights of stockholders and in some cases, changes must meet specific voting

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<sup>22</sup> CORPORATE LAWS COMMITTEE, AMERICAN BAR ASSOCIATION BUSINESS LAW SECTION, CORPORATE DIRECTOR'S GUIDEBOOK 19 (6<sup>th</sup> ed. 2011).

<sup>23</sup> BAARDA, *supra* note 8 at 4.

<sup>24</sup> *Id.*

<sup>25</sup> DROKE, *supra* note 4 at 78, 82.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> FEE ET AL., *supra* note 9 at 18.

<sup>29</sup> WORKING GROUP OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, NATIONAL COUNCIL OF FARMER COOPERATIVES, SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY 8 (2017).

<sup>30</sup> See *infra* pp. 43-50.

<sup>31</sup> DROKE, *supra* note 4 at 80; SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY *supra* note 29 at 10, 12.

<sup>32</sup> DROKE, *supra* note 4 at 78, 83; FEE ET AL., *supra* note 8 at 18; SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 29 at 12.

<sup>33</sup> FEE ET AL., *supra* note 9 at 18.

requirements.<sup>34</sup> Certain stock may also be subject to state or federal securities laws, which are discussed further in *Chapter 4: Cooperatives, Securities and Other Laws*.

In addition to the stock dividend and interest restrictions placed on cooperatives by state law, federal law may limit dividend and interest payments on cooperative stock.<sup>35</sup> Specifically, the Capper-Volstead Act provides that an agricultural cooperative may not pay stock dividends that exceed eight (8) percent annually for cooperatives to qualify for the limited anti-trust exemptions provided by the statute.<sup>36</sup> The Capper-Volstead Act is discussed more thoroughly later in this chapter.

Cooperatives, like other business corporations, may wish to repurchase stock from stockholders for various reasons.<sup>37</sup> For example, a cooperative may repurchase stock upon termination of a membership in the cooperative, prior to a merger, or for financial reasons.<sup>38</sup> State statutes, along with a cooperative's articles of incorporation or bylaws can limit stock repurchases by cooperatives.<sup>39</sup> Generally, stock repurchases by cooperatives have been upheld by courts as long as the cooperative does not impair its capital stock or financial status, including its ability to repay debt, by repurchasing the stock.<sup>40</sup>

Where a cooperative does offer stock with dividend rights, the state statute where the cooperative is organized and the cooperative's articles of incorporation and bylaws often outline the specifics of dividend payments,<sup>41</sup> including limitations<sup>42</sup> and the sources to be used for paying dividends.<sup>43</sup>

It is also worth noting that shareholders can bring a legal action to compel a cooperative to pay dividends.<sup>44</sup> An action against a cotton cooperative described below illustrates the factors that courts typically consider to determine if a cooperative has met its responsibility to shareholders in making decisions about dividend payments.<sup>45</sup> When dividend payments are permissible under the law and within the discretion of the board, courts generally review a board's action to determine if the board abused their discretion.<sup>46</sup> It is important for directors to understand their obligations to members and shareholders and seek competent advice regarding their decisions to make distributions to stockholders.

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<sup>34</sup> *Id.*

<sup>35</sup> FEE ET AL., *supra* note 9 at 18; SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 29 at 12.

<sup>36</sup> FEE ET AL., *supra* note 9 at 18.

<sup>37</sup> FEE ET AL., *supra* note 9 at 19; WORKING GROUP OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, NATIONAL COUNCIL OF FARMER COOPERATIVES, SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS TEXT 3 (2017).

<sup>38</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS TEXT, *supra* note 37 at 3; Email from Carolyn Eselgroth, Partner, Barrett, Easterday, Cunningham & Eselgroth, LLP, to author (Dec. 6, 2020) (on file with author).

<sup>39</sup> FEE ET AL., *supra* note 9 at 19.

<sup>40</sup> *Id.*

<sup>41</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 29 at 9-10.

<sup>42</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS TEXT, *supra* note 37 at 6.

<sup>43</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS TEXT, *supra* note 37 at 13.

<sup>44</sup> FEE ET AL., *supra* note 9 at 18.

<sup>45</sup> See *infra* p. 33.

<sup>46</sup> See *infra* p. 33; FEE ET AL., *supra* note 9 at 18.



## **Stock Dividend Payments and Board Discretion**

*Former members and preferred shareholders of a cotton gin cooperative in Arkansas sued the cooperative and its directors to compel payment of dividends on preferred stock and to establish a revolving fund for the retirement of preferred stock, as provided in the cooperative's bylaws.<sup>47</sup> Under the cooperative's charter, preferred stock could bear dividends up to 5% annually, "if earned and when declared by the board of directors," and the dividends were "to have preference over any and all other dividends or distributions declared in any year."<sup>48</sup> Despite these provisions, and the fact that most of the cooperative's capital was furnished by preferred stockholders, the board failed to pay dividends to preferred stockholders for a period of years.<sup>49</sup> Instead, the board authorized distributions to active patrons using a bonus structure for cotton seed.<sup>50</sup> The directors justified their decisions as a strategy to help the cooperative retain patrons.<sup>51</sup> However, the Arkansas Supreme Court did not find this justification convincing and determined that the cooperative board had abused its discretion in failing to make dividend payments or redeem preferred stock.<sup>52</sup> The court recognized that directors have discretion in apportioning a cooperative's net earnings and that courts should be careful not to "usurp the directors' function by attempting to declare in advance just what dividend should be paid."<sup>53</sup> However, the court explained that directors' decisions are subject to judicial review to determine if directors "acted in good faith and without an abuse of discretion."<sup>54</sup> It probably did not help the directors in this case that more than 80% of the cooperative's ginning business came from board members and that more than 80% of the cotton seed bonuses were paid to directors.<sup>55</sup>*

### **3.4 Patronage Refunds and Equity Redemptions**

Patronage and equity redemption systems are hallmarks of the cooperative model and integral to a cooperative's character and purpose.<sup>56</sup> These systems allow cooperatives to pass profits back to members and patrons in the form of cash or an allocation on the books and records of the cooperative.<sup>57</sup> The concepts embodied in patronage distributions or allocations were apparent in the rules of the Rochdale Equitable Pioneers Society, the cooperative store often credited with the birth of the modern cooperative movement.<sup>58</sup> As one scholar explained, "[p]atronage refunds and limited returns on capital together express the idea that cooperatives belong to the members as users, not to investors."<sup>59</sup>

<sup>47</sup> *Driver v. Producers Co-op., Inc.*, 233 Ark. 334, 345 S.W.2d 16, 17 (1961).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* at 19.

<sup>50</sup> *Id.* at 18-9.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 19-20.

<sup>53</sup> *Id.* at 20.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.* at 19.

<sup>56</sup> FREDERICK, *supra* note 1 at 11-13; DONALD A. FREDERICK & GENE INGALSBE, AGRICULTURE COOPERATIVE SERVICE U.S. DEPARTMENT OF AGRICULTURE, COOPERATIVE INFORMATION REPORT 9, WHAT ARE PATRONAGE REFUNDS? 2-3 (1993).

<sup>57</sup> FREDERICK & INGALSBE, *supra* note 56 at 2-3.

<sup>58</sup> BRETT FAIRBAIRN, CENTRE FOR THE STUDY OF CO-OPERATIVES UNIVERSITY OF SASKATCHEWAN, THE MEANING OF ROCHDALE: THE ROCHDALE PIONEERS AND THE COOPERATIVE PRINCIPLES 28-30.

<sup>59</sup> FAIRBAIRN, *supra* note 58 at 30.

Under state cooperative statutes, a cooperative's authority to implement patronage and equity redemption systems may derive directly from language referring to "distribution of net margins" or indirectly from references to the nonprofit nature of cooperatives.<sup>60</sup> Generally, a cooperative's bylaws will contain provisions that set up the financial structure of the cooperative, including the "framework supporting the calculation, payment and deduction of patronage distribution and per-unit retain allocations."<sup>61</sup> These financial provisions were described by a special Working Group of the Legal, Tax and Accounting Committee of the National Council of Farmer Cooperatives as "the significant components of the contract with members."<sup>62</sup>

Directors are typically responsible for authorizing, allocating and overseeing the patronage allocation, refund and equity redemption systems of the cooperative and making decisions regarding the timing, level, and manner of redemptions or refunds.<sup>63</sup> For example, the New York Cooperative Corporations Law provides that, "The net margins or net retained proceeds may, *in the discretion of the directors*, be distributed at least once every twelve months to members or patrons, by uniform distribution and calculated on such bases as the by-laws or marketing contract may prescribe."<sup>64</sup> It is imperative that directors understand the patronage and equity systems in their cooperative.

Cooperative members can bring lawsuits to compel the cooperative to pay patronage refunds or to redeem equity.<sup>65</sup> However, courts have repeatedly pointed out that decisions about patronage and equity are within cooperative directors' discretion and have reviewed the cooperative's organizing statute and bylaws to determine whether the board abused its discretion.<sup>66</sup>

In considering whether a court could order equity distributions after a lawsuit was filed by former members of a citrus marketing cooperative, the Florida Supreme Court decided that a court could not intervene to compel distribution of a cooperative's retained equity unless directors' refusal to redeem equity was an abuse of discretion, breach of trust, or based on fraud, illegality, or inequity.<sup>67</sup>

In some instances, directors have been found to have abused their discretion based on a cooperative's sound financial condition, directors' fiduciary duties to members, or based upon inequality in payments where payments had been made to members in like situations.<sup>68</sup> In one case, the North Dakota Supreme Court held that a cooperative with a policy of distributing patronage credits upon a patron's death was required to distribute

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<sup>60</sup> FEE ET AL., *supra* note 9 at 21.

<sup>61</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 29 at 16.

<sup>62</sup> *Id.*

<sup>63</sup> FEE ET AL., *supra* note 9 at 21.

<sup>64</sup> N.Y. COOP. CORP. LAW §72 (McKinney 2020) (emphasis added).

<sup>65</sup> FEE ET AL., *supra* note 8 at 21.

<sup>66</sup> *Lake Region Packing Ass'n, Inc. v. Furze*, 327 So. 2d 212 (Fla. 1976); *Doss v. Farmers Union Co-operative Gin Co.*, 1935 OK 703, 173 Okla. 70, 46 P.2d 950; *Vetrone v. Coop. Care*, 2014 WI App 24, 352 Wis. 2d 754, 843 N.W.2d 711.

<sup>67</sup> *Lake Region Packing Ass'n, Inc.*, 327 So. 2d 212, 215 (1976).

<sup>68</sup> FEE ET AL., *supra* note 9 at 21.

patronage credits to a member structured as a corporation upon the corporation's dissolution.<sup>69</sup> The cooperative's bylaws did not contain a provision to the contrary.<sup>70</sup>

Another important factor for the board of directors to keep in mind is that patronage refunds and equity redemption payments should not impair the financial standing of the cooperative. In a case reviewing a cooperative board's decision to suspend equity payments to a retired member because of the cooperative's poor financial performance, a Wisconsin Court of Appeals stated, "it is the fiduciary duty of the board of directors to *not* distribute any assets of the cooperative to redeem equity credit when it determines that the economic situation of the cooperative would be imperiled thereby."<sup>71</sup> The court also explained that it is the board's duty to ensure equity redemptions do not impair creditors' rights in the cooperative's assets.<sup>72</sup>

### **Vocabulary Check**

A **patronage refund** is "a payment from a cooperative to a patron from net margins based on quantity or value of business done with or for the patron" and paid as cash or additional equity investment in the cooperative.<sup>73</sup>

A **per unit retain** is "deduction by the cooperative from the proceeds of sale based on the value or quantity of products marketed for the patron,"<sup>74</sup> that is added to a patron's equity balance<sup>75</sup>.

**Equity capital** is the part of a cooperative's assets that are owned by members.<sup>76</sup>

**Equity redemption** is the cooperative's "payment of cash or other property to return [a member's] previously invested funds."<sup>77</sup>

### **3.5 Cooperatives and Antitrust Laws**

One area of law where the treatment of general corporations and agricultural cooperatives differ is federal and state antitrust laws.<sup>78</sup> This publication will not attempt to fully detail antitrust laws as they apply to agricultural cooperatives. The topic is complex. Antitrust issues can have serious impacts on cooperatives, and on directors individually, so it is important for cooperative directors to have a general understanding of the area.

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<sup>69</sup> *Schill v. Langdon Farmers Union Oil Co.*, 442 N.W.2d 408, 411–12 (N.D., 1989).

<sup>70</sup> *Id.*

<sup>71</sup> *Vetrone*, 2014 WI App 24, ¶ 32 (emphasis added).

<sup>72</sup> *Id.*

<sup>73</sup> LIONEL WILLIAMSON, COOPERATIVE EXTENSION SERVICE UNIVERSITY OF KENTUCKY, *THE FARMER'S COOPERATIVE YARDSTICK: UNDERSTANDING COOPERATIVE TERMINOLOGY* 3 (1998); FREDERICK & INGALSBE, *supra* note 54 at 2-3.

<sup>74</sup> FREDERICK & INGALSBE, *supra* note 56 at 6.

<sup>75</sup> WILLIAMSON, *supra* note 73 at 3.

<sup>76</sup> WILLIAMSON, *supra* note 73 at 3.

<sup>77</sup> FREDERICK & INGALSBE, *supra* note 56 at 5.

<sup>78</sup> DROKE, *supra* note 4 at 102-103; FEE ET AL., *supra* note 9 at 23.

Generally, antitrust laws in the United States prohibit business arrangements and actions that restrain trade or that monopolize or attempt to monopolize trade.<sup>79</sup> As a special counsel for the Department of Justice’s (DOJ) Antitrust Division explained, “antitrust laws are based on the notion that competitive market forces should play the primary role in determining the structure and functioning of our economy.”<sup>80</sup>

The Sherman Act is the seminal piece of federal antitrust law that makes “every contract, combination, or conspiracy in restraint of trade” and any “monopolization, attempted monopolization, or conspiracy or combination to monopolize” illegal.<sup>81</sup> For example, arrangements among competitors to fix prices, divide markets, and rig bids are automatic violations of the Sherman Act.<sup>82</sup>

Antitrust laws also exist at the state level.<sup>83</sup> However, state statutes generally provide that agricultural cooperatives do not violate state antitrust laws on account of their agreements with members or agreements with other agricultural cooperatives.<sup>84</sup> For example, Virginia’s Antitrust Act specifically provides that the act does not make illegal, “the activities of any agricultural or horticultural cooperative. . .”<sup>85</sup> This guide will not attempt to discuss the potential variations of antitrust laws at the state level. Rather, cooperative directors can consult with professionals in their states to understand their specific context.

There are multiple routes to liability under antitrust laws.

- First, the DOJ’s Antitrust Division can prosecute antitrust violations as both criminal and civil violations.<sup>86</sup> The Federal Trade Commission also shares antitrust enforcement powers with the DOJ.<sup>87</sup>
- Also, anyone injured by an antitrust violation can bring an action against an entity and against the directors and officers of that entity.<sup>88</sup>
- Additionally, where a corporation has violated certain provisions of antitrust laws, individual directors, officers, or agents who authorized, ordered, or carried out any of the illegal acts will be considered to have violated the laws.<sup>89</sup>
- A corporate officer who “knowingly participates in an illegal contract, combination, or conspiracy; authorizes, orders, or helps perpetuate the crime; or acts toward those ends in a representative capacity,” can be prosecuted under federal antitrust law.<sup>90</sup>

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<sup>79</sup> DROKE, *supra* note 4 at 101-102.

<sup>80</sup> Douglas Ross, Special Counsel for Agriculture, Antitrust Division, Dept. of Justice, Address to R-CALF USA Annual Convention: Antitrust Enforcement and Agriculture 12 (Jan.19, 2007)

<https://www.justice.gov/atr/file/519371/download>

<sup>81</sup> THE ANTITRUST LAWS, FEDERAL TRADE COMM’N <https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/antitrust-laws>

<sup>82</sup> *Id.*

<sup>83</sup> FEE ET AL., *supra* note 9 at 23.

<sup>84</sup> *Id.* at 30.

<sup>85</sup> VA. CODE ANN. §59.1-9.4(a)(2) (West 2020).

<sup>86</sup> THE ANTITRUST LAWS, FEDERAL TRADE COMM’N, *supra* note 81.

<sup>87</sup> FEE ET AL., *supra* note 9 at 27; THE ANTITRUST LAWS, FEDERAL TRADE COMM’N, *supra* note 81.

<sup>88</sup> FEE ET AL., *supra* note 9 at 24.

<sup>89</sup> *Id.* at 25.

<sup>90</sup> *Id.*

- Directors and officers who violate antitrust laws also expose themselves to liability under their general fiduciary duties,<sup>91</sup> which are discussed in *Chapter 2: Fiduciary Duties of Cooperative Directors*.

Despite these various routes to liability, where legal actions have been brought against cooperative directors and officers, liability has generally only been found in cases where the actors were grossly and culpably negligent in managing the cooperative.<sup>92</sup>

When it was under debate and in the decades following the enactment of the Sherman Act, some thought that the cooperative model itself might be considered a violation of the antitrust law.<sup>93</sup> However, the Capper-Volstead Act, passed in 1922, provides a limited exemption to antitrust laws for qualified agricultural cooperatives.<sup>94</sup> As a Supreme Court Justice later explained, “By allowing farmers to join together in cooperatives, Congress hoped to bolster their market strength and to improve their ability to weather adverse economic periods and to deal with processors and distributors.”<sup>95</sup>

### ***Capper Volstead Act: The ‘Magna Carta of Farmer Cooperatives’<sup>96</sup>***

*The Capper-Volstead Act states, “. . . persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers may act together in associations . . . in collectively processing, preparing for market, handling, and marketing . . . such products of persons so engaged. Such associations may have marketing agencies in common; and such associations and their members may make the necessary contracts and agreements to effect such purposes...”<sup>97</sup>*

<sup>91</sup> *Id.* at 27.

<sup>92</sup> *Id.* at 29.

<sup>93</sup> DROKE, *supra* note 4 at 102-103; DONALD A. FREDERICK, RURAL BUS.-COOP. SER., U.S. DEPT. OF AGRIC. COOPERATIVE INFORMATION REPORT 59, ANTITRUST STATUS OF FARMER COOPERATIVES: THE STORY OF THE CAPPER-VOLSTEAD ACT 25 (2002).

<sup>94</sup> DAVID VOLKIN, RURAL BUS. AND COOP. DEV. SERVICE, U.S. DEPT. OF AGRIC, COOPERATIVE INFORMATION REPORT 35, UNDERSTANDING CAPPER-VOLSTEAD 2, 9 (1995).

<sup>95</sup> *Nat’l Broiler Mktg. Ass’n v. U.S.*, 436 U.S. 816, 826 (1978).

<sup>96</sup> FREDERICK, *supra* note 93 at 1.

<sup>97</sup> VOLKIN, *supra* note 94 at 7. Since at least the early 2000’s, there has been debate about whether antitrust exemption for agricultural co-ops under the Capper Volstead Act is warranted given the current structure of agribusiness. CHRISTOPHER E. ONDECK & KATHLEEN CLAIR, ANTITRUST AND TRADE REGULATION, THE BUREAU OF NATIONAL AFFAIRS, INC., JUSTICE DEPARTMENT AND PRIVATE PLAINTIFFS TAKE AIM AT CAPPER-VOLSTEAD ACT’S PROTECTIONS FOR AGRICULTURE (2009) <https://www.crowell.com/documents/Justice-Department-and-Private-Plaintiffs-Take-Aim-At-Capper-Volstead-Act.pdf>. In 2009, an Assistant Attorney General for the DOJ’s Antitrust Division questioned the place of Capper-Volstead in modern agribusiness. *Id.* at 1. In 2010, the DOJ and USDA held a series of workshops to explore “competition in the agriculture sector” and in a summary highlighted a number of issues including anti-competitive mergers and market manipulation. U.S. DEPT. OF JUSTICE, COMPETITION AND AGRICULTURE: VOICES FROM THE WORKSHOPS ON AGRICULTURE AND ANTITRUST ENFORCEMENT IN OUR 21<sup>ST</sup> CENTURY ECONOMY AND THOUGHTS ON THE WAY FORWARD 23 (2012). In 2013, one legal scholar argued, “Congress should revise these acts, particularly the Capper-Volstead Act . . . to address the dramatically different nature of American agriculture in the 21st Century. Regrettably, the iconic status of the Capper-Volstead Act among farmers and politicians makes revision politically unlikely. Hence, judicial interpretation provides the only means to limit the unintended harmful consequences to both farmers and consumers of these historic relics.” Peter C. Carstensen, *Agricultural Cooperatives and the Law: Obsolete Statutes in a Dynamic Economy*, 58 S.D. L. Rev. 462, 462 (2013).

To qualify for the Capper-Volstead Act's limited exemption, an agricultural cooperative must meet specific structural requirements.<sup>98</sup>

- First, all cooperative members must be 'bone fide producers' of 'agricultural products.'<sup>99</sup> This requirement has been referred to as the 'membership purity' requirement<sup>100</sup> and it has significant implications, as discussed below. The law specifies that farmers, planters, ranchmen, dairymen, and nut or fruit growers are qualifying producers,<sup>101</sup> but this list is not exhaustive and the question of who is a producer of agricultural products can be quite technical<sup>102</sup>. Since the adoption of the Capper-Volstead Act, farming and ranching has become more complex, so directors would be well advised to consult with legal counsel to ensure they understand the definition under various scenarios to ensure compliance.
- Second, the cooperative must be operated for the mutual benefit of members as producers, generally requiring that the cooperative prioritize producer interests.<sup>103</sup>
- Third, at least half of the agricultural products marketed by the cooperative on an annual basis must be members' products.<sup>104</sup>
- Finally, the cooperative must utilize a "one-member, one-vote" system *or* limit capital dividends to 8% per year, but for various reasons many cooperatives satisfy *both* of these requirements.<sup>105</sup>

The Capper-Volstead Act's limited exemption does not absolve cooperatives from liability for all actions that restrain trade or create a monopoly. A publication by the law firm Dorsey & Whitney LLP, which has a robust cooperative practice area, explains that there are three types of conduct that would run agricultural cooperatives afoul of antitrust laws despite the limited exemption provided by Capper-Volstead, including:

1. conspiring or combining with non-agricultural producers to restrain trade;
2. predatory conduct, or conduct that is designed primarily to restrain trade or prevent competition with no apparent bona fide business purpose; and
3. undue price enhancement.<sup>106</sup>

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<sup>98</sup> DROKE, *supra* note 4 at 104.

<sup>99</sup> *Id.*; *Case-Swayne v. Sun-kist Growers*, 355 F. Supp. 408, 415 (C. D. Cal. 1971).

<sup>100</sup> Andrew J. Frackman & Kenneth O'Rourke, Presentation to New York State Bar Association Antitrust Section Executive Committee: The Capper Volstead Act Exemption and Supply Restraints in Agricultural Antitrust Actions (Feb. 16, 2011)

<https://nysba.org/NYSBA/Sections/Antitrust%20Law/Resources/Resource%20PDFs/TheCapper-VolsteadActpresentation.pdf>

<sup>101</sup> DROKE, *supra* note 4 at 105.

<sup>102</sup> *Id.* at 106-7.

<sup>103</sup> *Id.* at 108.

<sup>104</sup> *Id.* at 108-109.

<sup>105</sup> *Id.* at 108, 110.

<sup>106</sup> *Id.* at 114.

## **Membership Purity and the Capper-Volstead Act**

*For a cooperative to qualify for the limited exemption provided by Capper-Volstead, all members of the cooperative must be producers of agricultural products.<sup>107</sup> In 1978, the U.S. Supreme Court considered the stringency of this requirement in what is now a seminal case on the topic, National Broiler Marketing Association v. U.S.<sup>108</sup> The National Broiler Marketing Association (NBMA), formed in 1970 under Georgia law, marketed broiler chickens on behalf of members in addition to performing certain purchasing functions.<sup>109</sup> The cooperative included as many as 75 members, all of whom were involved in multiple stages of broiler production, including ownership of processing plants for slaughter and dressing birds for market.<sup>110</sup> All members also contracted with independent growers to some extent in the raising of their birds.<sup>111</sup> However, six cooperative members did not own or control any breeder flock or hatchery of their own and three members did not own a breeder flock, hatchery, or grow-out facility.<sup>112</sup> As a result, the Supreme Court held that the cooperative did not qualify for the limited exemptions granted by the Capper-Volstead Act because not all members of the cooperative were producers of agricultural products.<sup>113</sup> The Court explained, “[i]t is not enough that a typical member qualify, or even that most of NBMA’s members qualify.”<sup>114</sup> While the Court did not provide a succinct definition of a ‘producer,’ one Justice explained that the purpose of the Act was to permit “individual economic units working at the farm level to form cooperatives. . . .”<sup>115</sup> Generally, processors and manufacturers of finished agricultural products who are not themselves producing agricultural products would not be considered producers for the purpose of Capper-Volstead exemption.<sup>116</sup> A more recent federal court case held that the inclusion of one non-producer member in a cooperative could disqualify the cooperative from Capper-Volstead exemption.<sup>117</sup>*

Beginning around the mid-2000’s, there was an increase in private litigation against agricultural cooperatives testing the limits of their Capper-Volstead exemption.<sup>118</sup> These lawsuits are often brought by direct purchasers of products from agricultural cooperatives such as grocery stores, food service companies, food processors, and wholesalers, as well as indirect purchasers such as consumers and hospitals.<sup>119</sup> In multiple cases, the result has been a multi-million-dollar settlement against the cooperative.<sup>120</sup>

<sup>107</sup> *Id.* at 105.

<sup>108</sup> *Nat’l Broiler Mktg. Ass’n v. U.S.*, 436 U.S. 816 (1978).

<sup>109</sup> *Id.*

<sup>110</sup> *Id.* at 820-21.

<sup>111</sup> *Id.* at 821.

<sup>112</sup> *Id.* at 822.

<sup>113</sup> *Id.* at 828-29.

<sup>114</sup> *Id.* at 822-23.

<sup>115</sup> *Id.* at 832 (Brennan, J., concurring).

<sup>116</sup> *Id.*; DROKE, *supra* note 4 at 105.

<sup>117</sup> *In re Mushroom Direct Purchaser Antitrust Litig.* 621 F. Supp. 2d 274, 286 (E.D. Pa. 2009), *appeal dismissed*, 655 F.3d 158 (3d. Cir. 2011) (cited in DROKE, *supra* note 4 at 106).

<sup>118</sup> DROKE, *supra* note 4 at 103; John C. Monica, Jr. & James Pizzirusso, Presentation to American Agricultural Lawyers Association Agricultural Law Symposium: Agricultural Antitrust: Cases and Issues (Oct. 7, 2016).

<sup>119</sup> Monica Jr. & Pizzirusso, *supra* note 118.

<sup>120</sup> *Id.*

In 2008 a class action lawsuit was filed against 15 egg producers, including cooperatives.<sup>121</sup> The lawsuit alleged that the producers conspired to increase egg prices by instituting programs to increase laying-hen cage sizes, joining together in exports, and other activities.<sup>122</sup> The complex litigation was ongoing as of late 2020 with appeals pending,<sup>123</sup> but several defendants had settled for amounts estimated at over \$63,000,000.<sup>124</sup> In December 2019, a jury found no violation of antitrust laws by the egg producers in one of the cases.<sup>125</sup> Plaintiffs were seeking approximately \$1 billion in damages with the potential for trebling the amount to \$3 billion.<sup>126</sup> The ruling is being appealed.<sup>127</sup>

In early 2020, dairy cooperatives including the National Milk Producers Federation (NMPF), Agri-Mark, Inc., Dairy Farmers of America, Inc., and Land O'Lakes, Inc. settled a class action lawsuit alleging that a herd retirement program of the initiative Cooperatives Working Together (CWT), which involves 24 dairy cooperatives and individual producers, violated antitrust laws.<sup>128</sup> The CWT Herd Retirement Program operated from 2003 to 2010 and the settlement totaled \$220 million.<sup>129</sup> Additional private lawsuits against cooperatives have included actions against canned tuna, potato, and mushroom companies.<sup>130</sup>

In addition to private litigants, the DOJ's Antitrust Division has taken action against agricultural cooperatives alleged to have violated antitrust laws. In 2004, the DOJ brought an action against the Eastern Mushroom Marketing Cooperative (EMCC) alleging that a supply control program that involved the cooperative purchasing or leasing mushroom farms, shutting down the operations, and placing deed restrictions on the properties to remove them from mushroom production was a violation of antitrust law.<sup>131</sup> In settling the case, EMCC agreed to stop the practice of creating or filing deed restrictions and to nullify existing restrictions.<sup>132</sup>

Mergers and acquisitions in agriculture have also been a focus of antitrust enforcement by the DOJ.<sup>133</sup> For example, in May 2020 the DOJ's Antitrust Division announced a proposed settlement after investigation of the potential market effects of Dairy Farmers of America Inc. and Prairie Farms Dairy Inc. acquiring fluid milk processing plants from

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<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> Lin Rice, *Jury finds egg producers did not conspire to raise prices*, Columbus CEO (Feb. 23, 2020), <https://www.columbusceo.com/business/20200223/jury-finds-egg-producers-did-not-conspire-to-raise-prices>).

<sup>124</sup> Monica Jr. & Pizzirusso, *supra* note 118.

<sup>125</sup> Rice, *supra* note 123.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> Wayne Labs, *Butter and cheese class action lawsuit settled*, Food Engineering (Jan. 29, 2020), <https://www.foodengineeringmag.com/articles/98691-butter-and-cheese-class-action-lawsuit-settled>); *Who Is Part of CWT? Cooperatives Working Together*, <http://www.cwt.coop/membership/>. (last visited November 25, 2020).

<sup>129</sup> Labs, *supra* note 128.

<sup>130</sup> DROKE, *supra* note 4 at 103-104; Monica Jr. & Pizzirusso, *supra* note 118.

<sup>131</sup> ONDECK & CLAIR, *supra* note 97 at 2.

<sup>132</sup> *Id.*

<sup>133</sup> Ross, *supra* note 80 at 7.



the bankrupt Dean Foods Company.<sup>134</sup> The settlement required the acquirers to divest plants in Illinois, Wisconsin, and New England.<sup>135</sup> With the recent increased pace of consolidation among agricultural cooperatives,<sup>136</sup> an awareness of the scrutiny around antitrust issues is likely to serve cooperative directors well.

### **3.6 Conclusion**

Cooperatives provide significant benefits to their members. The cooperative business model, guided by internationally recognized principles, creates a unique set of roles and responsibilities for directors from making decisions about patronage refunds and equity redemption, to assessing opportunities for consolidation. These unique characteristics create important duties for directors as they govern their cooperative.

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<sup>134</sup> U.S. DEPT. OF JUSTICE OFFICE OF PUB. AFFAIRS, JUSTICE DEPARTMENT REQUIRES DIVESTITURES AS DEAN FOODS SELLS FLUID MILK PROCESSING PLANTS TO DFA OUT OF BANKRUPTCY (May 1, 2020) <https://www.justice.gov/opa/pr/justice-department-requires-divestitures-dean-foods-sells-fluid-milk-processing-plants-dfa>.

<sup>135</sup> *Id.*

<sup>136</sup> DAN KOWALSKI & CATHERINE MERLO, COBANK KNOWLEDGE EXCHANGE, CO-OP CONSOLIDATION 2 (2019) <https://www.cobank.com/-/media/files/ked/general/co-op-consolidation-jul2019.pdf?la=en&hash=B43C20776E9D205C9DB650A6C381BEF9AE6B1533>.

### 3.7 Director Self-Assessment

The unique characteristics of the cooperative model create special responsibilities for directors. These questions can help directors develop their understanding of the unique characteristics of their cooperative. Directors can talk with their cooperative's legal counsel or other advisors or request additional training where they want to learn more.

*What are some examples of the ways your cooperative upholds the internationally recognized cooperative principles?*

*Is your cooperative a stock cooperative? If yes, what classes and types of stock does your cooperative issue or have outstanding (e.g., common, preferred, etc.)?*

*Who is eligible to hold and be granted stock and in what states are they located?*

*Are these stockholders entitled to interest or dividend payments? Are there limitations to interest or dividend payments?*

*How does your cooperative determine who is a patron and eligible for patronage? Is there a written patronage policy in place?*

*Describe the process your board uses to make decisions about patronage allocations, payments and redemptions. Does the cooperative have any special patronage payment programs (i.e., if a patron reaches 80 years old or passes away)?*

*Is the cooperative a Capper-Volstead cooperative that requires members be agricultural producers? If yes, are all members agricultural producers as defined under the law?*

*Does your cooperative take advantage of the limited exemption under Capper-Volstead? Does a cooperative that your cooperative is a member of require you to be in compliance with Capper-Volstead?*

*What questions do you have about cooperatives and antitrust issues? List a few points about which you would like to develop your understanding.*



## Chapter 4: Cooperatives, Securities and Other Laws

Because of their unique structure, cooperatives often raise and maintain capital differently than other businesses.<sup>1</sup> While cooperatives rely on equity and debt like any other business, the ways that cooperatives raise initial equity and build additional equity over time is generally tied to the principles of user-ownership, democratic control by members, limited returns on capital, and distribution of net margins based on use or patronage.<sup>2</sup> A core principle underlying the financial structure of a cooperative is that “those people who use the cooperative should also finance the cooperative.”<sup>3</sup>

Federal and state securities laws can have implications for the ways cooperatives finance their operations.<sup>4</sup> While the definition is complex, in general, a security is “[a]n instrument that evidences the holder's ownership rights in a firm (e.g., a stock), the holder's creditor relationship with a firm or government (e.g., a bond), or the holder's other rights (e.g., an option).”<sup>5</sup> This chapter will review basic concepts in federal and

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**The information contained in this document is provided for educational purposes only. It is not legal advice and is not a substitute for the potential need to consult with a competent attorney licensed to practice law in the appropriate jurisdiction.**

<sup>1</sup> MICHAEL W. DROKE, DORSEY & WHITNEY LLP, *COOPERATIVE BUSINESS LAW: A PRACTICAL GUIDE TO THE SPECIAL LAWS GOVERNING COOPERATIVES* 77 (3d ed. 2020).

<sup>2</sup> *Id.* at 77-78; Mike Droke & Dave Swanson, Dorsey & Whitney LLP, *Capitalizing your Co-op: Financing Strategies to Retain the Cooperative Model* (Oct. 21, 2020); Kathryn J. Sedo, *The Application of Securities Laws to Cooperatives: A Call for Equal Treatment for Nonagricultural Cooperatives*, 46 Drake L. Rev. 259, 261 (1997).

<sup>3</sup> Frank A. Taylor & Patrick A. Reinken, *Are Financial Instruments Issued by Agricultural Cooperatives Securities? A Framework of Analysis*, 5 Drake J. Agric. L. 171, 174 (2000).

<sup>4</sup> Droke & Swanson, *supra* note 2.

<sup>5</sup> *Security*, Black's Law Dictionary (11<sup>th</sup> ed. 2019).

state securities laws and their application to agricultural cooperatives. The chapter will focus on areas where capitalizing a cooperative may implicate a director's liability under securities laws. However, the chapter is not intended to provide a comprehensive guide to understanding the unique capital structures of cooperatives, innovative strategies for capitalizing a cooperative, nor securities law. All are complex areas that are addressed in more detail by other resources.<sup>6</sup> Additionally, this guide will address issues for agricultural cooperatives. Other types of cooperatives may face special issues that are beyond the scope of this guide. Directors should consult with knowledgeable advisors if they have questions about securities and their cooperative.

#### 4.1 A Brief Overview of Securities Laws

State and federal laws govern the initial sale and issuance of securities and regulate markets for securities.<sup>7</sup> The laws help ensure that investors have the opportunity to base their investment decisions on adequate and accurate information.<sup>8</sup> It is important to note that some types of securities of agricultural cooperatives may be exempt from regulation under applicable state law.<sup>9</sup> If a cooperative is issuing securities in multiple states or outside their state of incorporation, federal securities laws will likely be triggered.<sup>10</sup>

At the federal level, the initial sale of securities is regulated by the Securities Act of 1933.<sup>11</sup> Any business or individual that “offer[s] or sell[s] securities to the public through interstate commerce” must abide by the Act and rules promulgated by the Securities and Exchange Commission (SEC), unless the offer or sale is otherwise exempt.<sup>12</sup> Generally, the law requires issuers of non-exempt securities to register the security with the SEC and provide a prospectus to potential investors.<sup>13</sup> The law imposes anti-fraud requirements, including liability for false statements or omissions of material fact, on both exempt and non-exempt securities.<sup>14</sup>

The Securities Exchange Act of 1934 regulates the market for securities through requirements for brokers, dealers, and exchanges.<sup>15</sup> Generally, the law includes reporting and registration requirements for issuers of securities, securities dealers, and security exchanges.<sup>16</sup> The law also prohibits manipulative or deceptive practices in the sale and exchange of securities, creating penalties and civil liability for violations.<sup>17</sup>

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<sup>6</sup> See Taylor & Reinken, *supra* note 3; Sedo, *supra* note 2.

<sup>7</sup> Taylor & Reinken, *supra* note 3 at 171-172; Sedo, *supra* note 2 at 264-265; James R. Baarda, Cooperatives and Securities Law Policy 1 (2007)

<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.631.1311&rep=rep1&type=pdf>.

<sup>8</sup> Taylor & Reinken, *supra* note 3 at 172; Sedo, *supra* note 2 at 264.

<sup>9</sup> See *infra* pp. 46-8.

<sup>10</sup> Taylor & Reinken, *supra* note 3 at 178.

<sup>11</sup> Sedo, *supra* note 2 at 264.

<sup>12</sup> Taylor & Reinken, *supra* note 3 at 178.

<sup>13</sup> Sedo, *supra* note 2 at 266-268.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 264-265.

<sup>16</sup> *Id.* at 268-269.

<sup>17</sup> *Id.*

## **What is a security?**

*Under federal law, the Securities Act of 1933 and the Securities Exchange Act of 1934 define the term ‘security,’ as any “...note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement . . . transferable share, investment contract . . . or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”<sup>18</sup> In addition, the United States Supreme Court has taken an expansive view of securities, stating that particular instruments should be examined to determine whether they are securities based on the “economic reality” of the instrument.<sup>19</sup> State statutes define securities for the purposes of state law.<sup>20</sup>*

In addition to federal laws, states also impose requirements on issuers of securities through “blue sky laws.”<sup>21</sup> Like federal securities laws, the goals of state blue sky laws are to ensure that investors are fully and accurately informed when making investment decisions.<sup>22</sup> Every state has adopted some form of state securities laws that generally regulate the issue and sale of securities through registration requirements, prohibitions on fraud, or both.<sup>23</sup>

### **4.2 Why Should Agricultural Cooperative Directors Be Alert to Securities Issues?**

At the federal level, the Securities Act of 1933 and the Securities Exchange Act of 1934 provide for the recovery of damages for certain violations of the laws.<sup>24</sup> For example, the laws allow the recovery of damages for injuries caused by manipulative or deceptive devices, from the sale of unregistered securities, from false registration statements, and from misleading prospectuses.<sup>25</sup> In some instances, damages may include both actual damages and reasonable attorney’s fees for the harmed party.<sup>26</sup> The Securities Act of 1933 also establishes criminal liability for fraud in the distribution of securities.<sup>27</sup>

Perhaps most importantly for cooperative directors, securities laws can impose personal liability on directors for violations. In a 1986 case, the U.S. District Court for the Western District of Arkansas held that demand notes issued by the Farmer’s Cooperative of Arkansas and Oklahoma, Inc. were securities under Arkansas securities laws and that cooperative directors were liable for the unregistered sale of these securities as a matter

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<sup>18</sup> Section 77b(1) of the Securities Act of 1933 and Section 78c(a)(1) of the Securities Exchange Act of 1934 *quoted in Sedo, supra* note 2 at 265.

<sup>19</sup> Taylor & Reinken, *supra* note 3 at 179-80. Courts have advanced at least two primary tests to determine whether an instrument is a security -- the “family resemblance test” and the *Howey* test, which are beyond the scope of this chapter. Taylor & Reinken, *supra* note 3 at 180. Readers interested in the details may consult Sedo, *supra* note 2 and Taylor & Reinken, *supra* note 3.

<sup>20</sup> Baarda, *supra* note 7 at 16.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 17.

<sup>24</sup> Taylor & Reinken, *supra* note 3 at 191 n.88.

<sup>25</sup> *Id.*

<sup>26</sup> Taylor & Reinken, *supra* note 3 at 186.

<sup>27</sup> Sedo, *supra* note 2 at 268.

of law.<sup>28</sup> The cooperative had been raising funds through a “Co-op Investment Program” in which the cooperative issued demand deposit notes to members and non-members who invested money in the cooperative with the promise to repay note holders with interest upon demand.<sup>29</sup> The cooperative issued demand notes as early as 1959 through the cooperative’s bankruptcy in 1984 at which time the cooperative had raised more than \$10,000,000 from more than 1,600 people.<sup>30</sup> Under Arkansas securities laws, persons in control of a seller of securities, including directors, were liable for the unregistered sale of securities in an amount equal to the consideration paid for the security plus 6% interest annually.<sup>31</sup> When they were sued by the demand note holders, the cooperative’s directors claimed in defense: (i) that the directors were unaware of their liability under state securities laws and corporate laws; (ii) that the directors relied on advice from lawyers and accountants and these professionals failed to inform the directors of the legal issues with the investment program; and (iii) that the state agency regulating securities did not alert the directors of potential issues with the program.<sup>32</sup> The court’s response to these claims is illustrative:

Ignorance of the law, of its characterization of a given transaction, is no excuse. The plaintiffs do not have to prove that the directors knowingly and wilfully (sic) trespassed the law, only that the Co-op sold unregistered securities. That alone makes a *prima facie* case against the directors. As long as the directors knew that the Co-op was selling demand notes, and they unanimously admit that they knew that, they cannot plead ignorance of the facts upon which liability is predicated. . . . The court believes that one cannot delegate responsibility to his lawyer when a securities violation is alleged. One doing so is liable and is left with an action for contribution against his counsellor.<sup>33</sup>

#### 4.3 Special Securities Issues for Cooperatives

Not all financial instruments utilized by cooperatives are securities. In 1975, the U.S. Supreme Court held that a cooperative’s membership stock was not a security under federal law because of the characteristics of the stock.<sup>34</sup> The membership stock did not confer a right to receive dividends, the stock was not negotiable, the stock did not grant voting rights in proportion to shares owned, and the stock’s value could not appreciate.<sup>35</sup> The case has been read to mean that instruments that evidence membership interests in

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<sup>28</sup> *Robertson v. White*, 635 F. Supp. 851 (W.D. Ark. 1986). This case was quite complex and involved a number of issues brought by a bankruptcy trustee and a class of co-op members, distributees of unpaid patronage dividends, and holders of co-op demand notes, including fraud, violations of both state and federal securities laws, breach of contract, negligence, and breach of fiduciary duty. The plaintiffs sued the co-op’s management group, directors, accountants, and attorneys. The litigation included multiple appeals to the Supreme Court of the United States on separate issues, including *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

<sup>29</sup> *Robertson v. White*, 635 F. Supp. at 863; KEN D. DUFT & ROBERT L. ZAGELOW, WASHINGTON STATE UNIVERSITY COOPERATIVE EXTENSION AGRIBUSINESS MANAGEMENT, COOPERATIVE DIRECTOR LIABILITY EXPOSURE: ISSUES AND RESOLUTIONS 2 <https://studylib.net/doc/12680603/cooperative-director-liability-exposure--issues-and-resol...>

<sup>30</sup> DUFT & ZAGELOW, *supra* note 29 at 2.

<sup>31</sup> *Robertson v. White*, 635 F. Supp. at 865.

<sup>32</sup> *Robertson v. White*, 635 F. Supp. at 865, 867.

<sup>33</sup> *Robertson v. White*, 635 F. Supp. at 867.

<sup>34</sup> Sedo, *supra* note 2 at 274-275.

<sup>35</sup> *Id.* at 275.

a cooperative, rather than investment interests, are not securities under federal law.<sup>36</sup> In *Great Rivers Cooperative v. Farmland Industries*, Farmland converted the stock of previous cooperative members, which they had received as retained patronage refunds while they were still active cooperative members, into ‘capital credits.’<sup>37</sup> The court determined that the capital credits were not securities primarily because they represented membership interests in the cooperative.<sup>38</sup> As other scholars have explained, “patronage dividends issued to cooperative patrons in the form of stock or other equity certificates are . . . not securities. . . [t]he patron that receives the stock or equity credit in lieu of a cash patronage dividend is not making an investment in the way that term is usually understood and has been interpreted by the Supreme Court.”<sup>39</sup>

Further, not all securities fall within the purview of state and federal regulations. For example, the Securities Act of 1933 exempts securities issued by farmer cooperatives that are tax exempt under section 521 of the Internal Revenue Code.<sup>40</sup> One well known agricultural cooperative, CROPP Cooperative, which markets various products including milk under the brand name Organic Valley, is a 521 cooperative that has utilized this exemption for a preferred stock program.<sup>41</sup> From 2004 to 2010, Organic Valley raised more than \$40 million by offering preferred stock to outside investors.<sup>42</sup> The preferred stock offers a 6% annual dividend and limited voting rights.<sup>43</sup>

The Securities Exchange Act of 1934 also exempts cooperatives qualifying under the Agricultural Marketing Act as well as cooperatives that “supply commodities or services primarily for the benefit of members where the security is issued to patrons of the cooperative, no dividend is paid on the security, and the security is transferable only to a successor in interest or occupancy of the premises served.”<sup>44</sup> Additionally, as of 2007, farmer cooperatives were exempt from part or all of the securities laws in 42 states.<sup>45</sup> The specifics of these exemptions vary.<sup>46</sup> For example, in Washington, transactions by a cooperative that meet the following requirements are exempt from state securities law registration requirements: (i) the transaction does not involve advertising or public solicitation, (ii) the transaction represents “a contribution of capital to the association by a person who is or intends to become a member or patron of the association,” and (iii) the instrument is non-transferable except in certain limited circumstances, such as upon death.<sup>47</sup>

Certain common capitalization strategies and instruments used by cooperatives do generally qualify as securities and require the cooperative to follow applicable securities

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<sup>36</sup> Taylor & Reinken, *supra* note 3 at 189.

<sup>37</sup> Taylor & Reinken, *supra* note 3 at 180.

<sup>38</sup> *Id.* at 182.

<sup>39</sup> Sedo, *supra* note 2 at 282.

<sup>40</sup> *Id.* at 270.

<sup>41</sup> Droke & Swanson, *supra* note 2.

<sup>42</sup> MARJORIE KELLY, OWNING OUR FUTURE: THE EMERGING OWNERSHIP REVOLUTION, 205-206 (2012).

<sup>43</sup> *Id.*

<sup>44</sup> Sedo, *supra* note 2 at 280.

<sup>45</sup> Baarda, *supra* note 7 at 18.

<sup>46</sup> Sedo, *supra* note 2 at 279-80.

<sup>47</sup> DROKE, *supra* note 1 at 80-81.

laws. For example, preferred stock offerings, which may be used to generate capital for a cooperative from members or non-members, are considered securities and must either comply with the requirements of state and federal law, as applicable, or fall under an exemption.<sup>48</sup> CHS, Inc., an agricultural cooperative in the grain, food, and energy sectors, has raised significant capital through a preferred stock program where the stock is publicly traded on the NASDAQ exchange.<sup>49</sup> As of early 2021, approximately 12.3 million preferred shares of CHS, Inc. were owned largely by institutions and mutual funds, representing a market capitalization of more than \$356 million.<sup>50</sup> Also, as the case of the Farmers Co-op of Arkansas and Oklahoma, Inc. previously discussed illustrates, promissory notes offered by a cooperative may be considered securities.<sup>51</sup> Additionally, stock or equity investments that are not tied to membership or patronage dividends, including investments by members, may be considered securities.<sup>52</sup>

#### 4.4 Other Laws and Potential Criminal Liability

In some instances, a director's conduct in the course of their cooperative duties could result in criminal liability. Criminal liability can result in indictment, fines, debarment, probation, and imprisonment.<sup>53</sup>

Under the "responsible corporate officer doctrine" established by the U.S. Supreme Court in *United States v. Dotterweich* and refined in *United States v. Park*, corporate officers can be held criminally liable for a corporation's violations of regulatory offenses, even if the officer is unaware of the wrongdoing, if the officer had the "authority to exercise control over the activities that caused the illegal conduct" or "[f]ailed to enact measures to prevent the illegal conduct or, if having implemented control systems, knew of possible violations and failed to carry out their duty to search for and correct them."<sup>54</sup>

It is impractical for a director to know all details of every regulation that may be applicable to the cooperative's business. However, it is helpful when a cooperative board has knowledge of all elements of the cooperative's business and generally knows what federal and state agencies and regulations apply to the cooperative. Most cooperatives have divisions and/or employees focused on key areas that ensure compliance with laws and regulations, such as accounting, human resources and safety. The board may also have or consider adding an audit/risk committee to provide guidance and recommendations to management to ensure compliance.

Generally, a cooperative's business model will often impact risk and compliance measures. A more complex cooperative business is likely subject to more laws and regulations. A typical agronomy and grain cooperative that is buying and selling goods is

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<sup>48</sup> *Id.*

<sup>49</sup> Droke & Swanson, *supra* note 2; CHS Inc (CHSCP:NASDAQ), CNBC <https://www.cnbc.com/quotes/?symbol=CHSCP> (last visited Jan. 6, 2021).

<sup>50</sup> CHS Inc (CHSCP:NASDAQ), *supra* note 49.

<sup>51</sup> See *supra* pp. 45-6.

<sup>52</sup> Sedo, *supra* note 2 at 283.

<sup>53</sup> CRIMINAL AND CIVIL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS, Practical Law Practice Note 6-501-9459, Westlaw (2020).

<sup>54</sup> *Id.*



regulated much differently than a cooperative that is processing commodities or food, manufacturing goods or providing services.

To understand when a federal agency may consider prosecuting a corporate official under the responsible corporate officer doctrine, the 2020 Regulatory Procedures Manual from the Food and Drug Administration outlined various factors the agency evaluates when considering prosecution, including the individual's position in the company, relationship to the violation, authority to correct or prevent the violation, harm to the public, and the seriousness of the violation, among other factors.<sup>55</sup>

Of course, cooperative directors who knowingly commit violations of certain laws may be held criminally liable. For example, cooperative directors who run afoul of antitrust laws can face criminal penalties, as discussed in *Chapter 3: The "Cooperative Difference" in Director Responsibilities*.<sup>56</sup> Additionally, enterprises in agriculture and food are subject to various federal and state regulations that may impose criminal liability by statute or under the responsible corporate officer doctrine.<sup>57</sup>

### **A Cautionary Tale: Farmers Cooperative Society**

*In 2019, a federal grand jury indicted the former general manager and assistant general manager of the Farmers Cooperative Society in Sioux Center, Iowa on charges of fraud.<sup>58</sup> The charges alleged that the two mixed lower-valued grains, like oats, with soybeans in violation of the U.S. Grain Standards Act.<sup>59</sup> Allegedly, the two were trying to deceive customers and inspectors about the quality and quantity of grain the cooperative was selling and storing, in part, to overvalue the cooperative's grain inventory to a lender.<sup>60</sup> The charges alleged that the activity took place from 2011 through the spring of 2017 when the general manager was suspended by the board, although the general manager denied wrongdoing, claiming that grain blending took place only when customers requested it.<sup>61</sup>*

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<sup>55</sup> U.S. FOOD & DRUG ADMIN., REGULATORY PROCEDURES MANUAL: CHAPTER 6: JUDICIAL ACTIONS 55 (2020) <https://www.fda.gov/media/71837/download>; CRIMINAL AND CIVIL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS, *supra* note 53.

<sup>56</sup> See *supra* pp. 35-7.

<sup>57</sup> CRIMINAL AND CIVIL LIABILITY FOR CORPORATIONS, OFFICERS, AND DIRECTORS, *supra* note 53; DOUGLAS FEE, ALLEN C. HOBERG, & LINDA GRIM McCORMICK, U.S. DEP'T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 34, DIRECTOR LIABILITY IN AGRICULTURAL COOPERATIVES 10-12 (1996).

<sup>58</sup> Nick Hytrek, *Former Sioux Center co-op officers charged with fraud*, Sioux City Journal, Dec. 24, 2019 [https://siouxcityjournal.com/news/local/crime-and-courts/former-sioux-center-co-op-officers-charged-with-fraud/article\\_9a1469ee-63cd-5344-9c6d-cc0c4cea298b.html](https://siouxcityjournal.com/news/local/crime-and-courts/former-sioux-center-co-op-officers-charged-with-fraud/article_9a1469ee-63cd-5344-9c6d-cc0c4cea298b.html).

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

## 4.5 Conclusion

Cooperative principles impact how cooperatives raise capital at their formation and over time.<sup>62</sup> As the cooperative deploys capitalization strategies, directors must be alert to special issues created by securities laws, especially because of the implications for directors' personal liability.<sup>63</sup> The laws and regulations governing securities at the federal and state level are intended to protect investors and potential investors.<sup>64</sup> The cooperative scholar, James Baarda, pointed to four major factors that highlight the importance of securities laws for cooperatives:

1. the "severity of implications of a securities problem for the cooperative and its members, as well as the personal liability of the directors, officers, and advisors;"
2. "increasing scrutiny of all types of financial arrangements as a general phenomenon in business;"
3. the "increased complexity of cooperative finance;" and
4. severe losses experienced by some cooperatives that impact farmer-members, employees, and the community.<sup>65</sup>

In addition, it is helpful for cooperative directors to understand the operations of the cooperative's business, including the state and federal laws and regulations that apply to the enterprise as well as the divisions or employees ensuring the cooperative's compliance with these laws and regulations. In some instances, directors may be held responsible for the violation of certain laws or regulations.<sup>66</sup>

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<sup>62</sup> Sedo, *supra* note 2 at 261-264.

<sup>63</sup> See *supra* pp. 45-6.

<sup>64</sup> Taylor & Reinken, *supra* note 3 at 172.

<sup>65</sup> Baarda, *supra* note 7 at 1-2.

<sup>66</sup> See *supra* p. 48-9.

#### 4.6 Director Self-Assessment

It is important for cooperative directors to understand their responsibilities under securities and other laws as well as the strategies that their cooperative is employing to finance the enterprise. The following checklist is intended to help directors identify areas where they can improve their understanding of their cooperative. In *Robertson v. White*, the court explained:

[W]hat is the duty of a director who knows that his corporation is selling securities, or “demand notes”? That is very simple. His duty is to assure himself that the notes are indeed registered, and, if not, to stop the sales and to procure registration of the issue, or a valid exemption. Moreover, this duty is non-delegable.<sup>67</sup>

	Yes	No
<i>I understand the strategies that my cooperative uses to build capital.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>Does your cooperative issue securities?</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>If yes, what kind of securities does your cooperative issue?</i>		
<i>If yes, are there restrictions on the securities being issued?</i>		
<i>Is the cooperative in compliance with applicable securities laws?</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>Does the cooperative issue or hold demand notes?</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>Do you know which states the holders of securities or demand notes reside in?</i>		
<i>When my cooperative board is evaluating new strategies to build capital or reviewing existing systems of capitalization, I consult knowledgeable experts and ask questions to clarify my understanding.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I recognize the importance of exploring potential legal issues that raise concern rather than relying uncritically on the assurances of others.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>Does the cooperative board have a process to review and assess the cooperative’s risk and compliance issues?</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>Are you familiar with all of the cooperative’s divisions and the types of goods and services the cooperative provides?</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>Do you have a general idea of the various federal and state laws and regulations the cooperative is subject to?</i>	<input type="checkbox"/>	<input type="checkbox"/>

<sup>67</sup> *Robertson v. White*, 635 F. Supp. 851, 868 (W.D. Ark. 1986).



## Chapter 5: Risk Management Tools for Cooperative Directors

Cooperatives depend on their members to provide the leadership that drives their success. Serving on a cooperative board is an important responsibility. The goal of this guide is to inform directors about potential legal issues so they can make informed decisions as they do the important work of leading their cooperative. As they consider potential legal risks, directors may be asking themselves: How can I mitigate potential risks and protect myself from potential liability?

As discussed in *Chapter 2: Fiduciary Duties of Cooperative Directors*, one of a cooperative director's main legal responsibilities is meeting their fiduciary duties, which includes ensuring they are reasonably informed as they make decisions.<sup>1</sup> Whether a director is new to the board or simply has not reviewed the information for some time, they can help mitigate their legal risks by familiarizing themselves with:

- the cooperative's business plan;
- how the cooperative makes money, including how individual divisions of the cooperative create revenue, the cash cycles of the business, and the overall profitability of the cooperative;

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**The information contained in this document is provided for educational purposes only. It is not legal advice and is not a substitute for the potential need to consult with a competent attorney licensed to practice law in the appropriate jurisdiction.**

<sup>1</sup> CORPORATE LAWS COMMITTEE, AMERICAN BAR ASSOCIATION BUSINESS LAW SECTION, CORPORATE DIRECTOR'S GUIDEBOOK 19 (6<sup>th</sup> ed. 2011); DOUGLAS FEE, ALLEN C. HOBERG, & LINDA GRIM McCORMICK, U.S. DEP'T OF AGRIC. RURAL BUS. COOP. SERV. COOPERATIVE INFORMATION REPORT 34, DIRECTOR LIABILITY IN AGRICULTURAL COOPERATIVES 5-6 (1996).

- the current financial position of the cooperative;
- the performance of the cooperative compared with peers and competitors;
- risks facing the cooperative, including environmental, financial, regulatory, cybersecurity and privacy, economic, and reputational risks; and
- the cooperative’s strategic goals.<sup>2</sup>

With this general consideration underlying the remainder of the chapter, we will explore common tools that cooperatives use to limit legal risks.

### 5.1 Statutory Limits on Liability

State cooperative and corporate laws often provide specific immunities or protections for directors.<sup>3</sup> For example, a state statute may allow the cooperative to remove or limit a director’s personal liability to the cooperative or to members for monetary damages that result from a breach of the director’s fiduciary duties.<sup>4</sup> These provisions may be referred to as exculpation provisions.<sup>5</sup> However, in some cases exculpation provisions will not protect a director who has breached their duty of loyalty, acted in bad faith, or acted in a way they knew was illegal.<sup>6</sup>

To provide directors the benefits of an exculpation provision, a cooperative may have to include a provision in their articles of incorporation or bylaws.<sup>7</sup> Directors can review their cooperative’s governing documents to see if it includes an exculpation provision or consult the cooperative’s legal counsel to understand whether protection is provided.

#### **Real World Example: Exculpation Provision**

*Exculpation provisions are based on the law of the state where the cooperative is incorporated and can vary from state to state.<sup>8</sup> Minnesota’s cooperative law provision on exculpation is included below for illustration. To be effective, the law requires a cooperative to include an exculpation provision in its articles of incorporation or bylaws. Additionally, the cooperative cannot completely eliminate directors’ liability using an exculpation provision – a director will still be liable for breaches of their duty of loyalty, knowing violations of the law, and more, despite the cooperative having adopted an exculpation provision.*

<sup>2</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 15.

<sup>3</sup> MICHAEL W. DROKE, DORSEY & WHITNEY LLP, COOPERATIVE BUSINESS LAW: A PRACTICAL GUIDE TO THE SPECIAL LAWS GOVERNING COOPERATIVES 59 (3d ed. 2020); CORPORATE LAWS COMMITTEE, *supra* note 1 at 127.

<sup>4</sup> Michael E. Traxinger, Corporate Attorney Agtegra Cooperative, Fiduciary Duties of the Board of Directors (April 26, 2018); HOLLY J. GREGORY, REBECCA GRAPSAS, & CLAIRE H. HOLLAND, CORPORATE GOVERNANCE AND DIRECTORS’ DUTIES IN THE UNITED STATES: OVERVIEW, PRACTICAL LAW COUNTRY Q&A w-011-8693, Westlaw (2020); FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, PRACTICAL LAW PRACTICE NOTE OVERVIEW 6-382-1267, Westlaw (2020); DROKE, *supra* note 3 at 59-61.

<sup>5</sup> FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 4.

<sup>6</sup> *Id.*; DROKE, *supra* note 3 at 60-61; CORPORATE LAWS COMMITTEE, *supra* note 1 at 127.

<sup>7</sup> DROKE, *supra* note 3 at 60-61; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 4; WORKING GROUP OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, NATIONAL COUNCIL OF FARMER COOPERATIVES, SAMPLE BYLAWS PROJECT: OVERVIEW OF COOPERATIVE ARTICLES OF INCORPORATION 3-4 (2017).

<sup>8</sup> WORKING GROUP OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, NATIONAL COUNCIL OF FARMER COOPERATIVES, SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY 31 (2017).

Under Minnesota law §308B.465:

**“Subdivision 1. Articles may limit liability.** A director's personal liability to the cooperative or members for monetary damages for breach of fiduciary duty as a director may be eliminated or limited in the articles or bylaws except as provided in subdivision 2.

**Subd. 2. Restrictions on liability limitation.** The articles or bylaws may not eliminate or limit the liability of a director:

- (1) for a breach of the director's duty of loyalty to the cooperative or its members;
- (2) for acts or omissions that are not in good faith or involve intentional misconduct or a knowing violation of law;
- (3) for knowing violations of securities laws or for illegal distributions;
- (4) for a transaction from which the director derived an improper personal benefit; or
- (5) for an act or omission occurring before the date when the provision in the articles or bylaws eliminating or limiting liability becomes effective.”<sup>9</sup>

## 5.2 Indemnification

In most states, cooperative or corporate laws permit cooperatives to indemnify their directors.<sup>10</sup> Indemnification is “the action of compensating for loss or damage sustained.”<sup>11</sup> Where a director is a party to a legal proceeding that arises from their board service, the cooperative may be permitted, or in some cases required, to defend the director in the action or to reimburse the director for reasonable expenses resulting from their own defense of the claim.<sup>12</sup> Indemnification may also be available in connection with threatened actions or proceedings.<sup>13</sup> Indemnification typically covers a damage award against a director as well as expenses of investigation or defense of the claim, including legal fees.<sup>14</sup> Indemnification could be provided in civil or criminal proceedings.<sup>15</sup>

Indemnification is a valuable tool to have in the toolbox for a cooperative’s board of directors, but it is not a license for a director to engage in misconduct at the cooperative’s expense. Where cooperative directors acted in bad faith, knowingly violated the law (even if for the benefit of the cooperative) or did not act in the best interests of the cooperative, they may not be indemnified.<sup>16</sup> In some cases, a director may be required to successfully defend against a claim to be indemnified.<sup>17</sup>

Often, state laws allow advances of funds to persons who will be indemnified before their liability is determined, unless the person was grossly negligent or willfully harmed the

<sup>9</sup> MINN. STAT. ANN. §308B.465 (West 2020).

<sup>10</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 128-129; SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 8 at 31.

<sup>11</sup> *Indemnification*, Black’s Law Dictionary (11<sup>th</sup> ed. 2019).

<sup>12</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 128-129; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 4.

<sup>13</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 8 at 32.

<sup>14</sup>*Id.*

<sup>15</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 128.

<sup>16</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 128; FEE ET AL. *supra* note 1 at 30-31; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 4.

<sup>17</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 128-9.

cooperative.<sup>18</sup> However, directors may be required to agree that they will repay advances if they are not ultimately entitled to indemnification.<sup>19</sup>

Where can a director look to understand their cooperative's indemnification or advance policies? A director can consult their cooperative's legal counsel or look to the cooperative's statute of incorporation, articles of incorporation and bylaws, which may outline the right of indemnity for directors and others.<sup>20</sup> A director could also look to the cooperative's policy book or ask the board chair or a more experienced director, followed by confirmation with the cooperative's legal counsel.

### ***Real World Example: Sample Bylaw Provision***

*Indemnification provisions are based on the law of the state where the cooperative is incorporated.<sup>21</sup> A sample provision on indemnification from the National Council of Farmer Cooperatives Sample Bylaws Project is included below for illustration. Notice that Section 9.1 provides as broad an indemnification to directors, and others, as the state where the cooperative is incorporated allows.*

#### *Indemnification*

***“Section 9.1 Right of Indemnity.* The Cooperative shall indemnify and advance expenses [to any person, including] any director, officer, employee or agent of the Cooperative, for such expenses and liabilities, in such manner and under such circumstances, to the fullest extent permitted by applicable law.”<sup>22</sup>**

### **5.3 Insurance**

Another option for the board of directors to mitigate risk is to purchase director's and officer's liability insurance, also called D&O liability insurance, to both protect directors and officers from losses they might incur in their service to the corporation as well as to protect the cooperative.<sup>23</sup> Insurance and indemnification are closely connected.<sup>24</sup> A publication by the National Council of Farmer Cooperatives Legal, Tax and Accounting Committee explained,

[I]nsurance coverage can be beneficial to both the cooperative and the protected persons. From the cooperative's point of view, insurance can provide a stable and affordable means of funding the cooperative's obligation to indemnify the protected person, subject to applicable policy provisions. From the protected person's point of view, the existence of the

<sup>18</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 8 at 31.

<sup>19</sup> *Id.*; CORPORATE LAWS COMMITTEE, *supra* note 1 at 128-129.

<sup>20</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 8 at 31.

<sup>21</sup> *Id.* at 32.

<sup>22</sup> WORKING GROUP OF THE LEGAL, TAX AND ACCOUNTING COMMITTEE, NATIONAL COUNCIL OF FARMER COOPERATIVES, SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS TEXT 19 (2017).

<sup>23</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 129; HELEN K. MICHAEL & VIRGINIA R. DUKE, DIRECTORS AND OFFICERS LIABILITY INSURANCE POLICIES, PRACTICAL LAW PRACTICE NOTE 2-504-6515, Westlaw (2020).

<sup>24</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS COMMENTARY, *supra* note 8 at 32.

policy helps to ensure that there will be funds available from which to satisfy an indemnification claim in the case of, for example, the insolvency of the cooperative.<sup>25</sup>

D&O liability insurance is a complex field, and this chapter will not cover the tool in detail. Cooperative directors can familiarize themselves with their cooperative's D&O liability insurance coverage to understand whether they have a current policy in place and the policy's general scope and key exclusions.

It is common for D&O liability insurance to cover:

- directors and officers from personal loss as a result of their service to the corporation, for example, if the corporation is not willing or able to indemnify or advance costs because of legal bars, the corporation's bylaws, or insolvency;
- the corporation for indemnifications or advances to officers and directors; and
- the corporation for claims against it.<sup>26</sup>

D&O liability insurance policies typically "require[] the insurer to indemnify the 'insured persons' against 'losses' arising from 'claims' made against them during the policy period for 'wrongful acts.'" <sup>27</sup> The policy's definitions of these underlined terms will determine the scope of the coverage in important ways.<sup>28</sup>

Like indemnification, D&O liability insurance is not a license for directors to act irresponsibly or illegally without repercussions. While coverage of 'wrongful acts' could include breaches of duty, errors, misstatements, or omissions, the term often *expressly excludes* intentional dishonesty, willful violations of rules or laws, or criminal acts.<sup>29</sup> D&O liability insurance coverage often excludes fines, penalties, and illegal profits and claims asserted or subject to notice prior to the policy's term.<sup>30</sup> Coverage might also exclude claims by one insured party against another party insured under the same policy.<sup>31</sup>

Recent trends in D&O liability insurance illustrate areas where directors might encounter legal challenges that can trigger their D&O liability coverage, including:

- class action securities lawsuits, including those connected with mergers and acquisitions;
- cybersecurity-related lawsuits, such as those related to consumer data breaches;
- privacy-related issues linked to the use or misuse of data; and
- lawsuits regarding environmental and climate-change related disclosures.<sup>32</sup>

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<sup>25</sup> *Id.*

<sup>26</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 129; MICHAEL & DUKE, *supra* note 23.

<sup>27</sup> MICHAEL & DUKE, *supra* note 23 (emphasis added).

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> Kevin LaCroix, *The Top Ten D&O Stories of 2019*, The D&O Diary (Jan 5., 2020),

<https://www.dandodiary.com/2020/01/articles/director-and-officer-liability/the-top-ten-do-stories-of-2019/>.



### **Real World Example: Sample Bylaw Provision**

*A sample provision on insurance from the National Council of Farmer Cooperatives Sample Bylaws Project is included below for illustration. The provision on insurance allows but does not require the cooperative to maintain D&O insurance.*

#### Insurance

**“Section 9.2 Insurance.** *The Cooperative may purchase and maintain insurance on behalf of [any person, including] any director, officer, employee or agent of the Cooperative against liability asserted against and incurred by such person in such person’s official capacity, whether or not the Cooperative would have been required to indemnify such person against such liability under Section 9.1 hereof.*”<sup>33</sup>

### **5.4 Audits, Abstention, Policies, Procedures, and Attorneys**

As discussed in *Chapter 2: Fiduciary Duties of Cooperative Directors*, cooperative directors have a right to rely on experts who they reasonably believe are competent, including accountants, attorneys, cooperative officers, cooperative employees, and auditors, assuming the directors have no knowledge that contradicts the experts’ reports or information.<sup>34</sup> Cooperative directors might assume that as long as they have an audit or an attorney review in hand, they can escape liability. However, the right to rely on certain parties does not remove directors’ oversight responsibilities,<sup>35</sup> seeking the advice of experts simply shows that directors exercised care in decision making.<sup>36</sup>

In some instances, directors may still be accused of wrongdoing or neglect of their duties despite having relied on experts. The case study of United Producers, Inc. below is one example where cooperative directors were accused of neglecting their duties despite having taken due diligence steps.<sup>37</sup>

### **Case Study: United Producers, Inc.**

*In 1999, Producers Livestock Association (PLA) and Missouri Farmers Association Livestock Association (MFA) merged to become United Producers, Inc. (UPI).<sup>38</sup> Today, UPI serves 35,000 members in Ohio, Kentucky, Indiana, Illinois, Michigan, Missouri, and Tennessee handling about 3 million head of livestock annually.<sup>39</sup>*

*At the time PLA and MFA merged, MFA was a passive owner in a company that conducted a cattle order buying and marketing business with producers primarily in Kansas, Nebraska, and Iowa.<sup>40</sup> Following the merger, UPI remained a passive investor*

<sup>33</sup> SAMPLE BYLAWS PROJECT: SAMPLE BYLAWS TEXT, *supra* note 22 at 19.

<sup>34</sup> See *supra* p. 15.

<sup>35</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 21.

<sup>36</sup> FEE ET AL., *supra* note 1 at 5.

<sup>37</sup> See *infra* p. 57-8.

<sup>38</sup> Frayne Olson, *United Producers Inc. Chapter 11 Restructuring*, 23 J. of Cooperatives 130, 130 (2009).

<sup>39</sup> ABOUT UPI, United Producers, Inc. <https://www.uproducers.com/about-upi/> (last visited Jan. 7, 2021).

<sup>40</sup> Olson, *supra* note 38 at 131; Interview with Dennis Bolling, Former CEO, United Producers, Inc. (Sept. 28, 2020).

*in the company, which was managed and operated by an entity owned and controlled by George Young and Kathleen McConnell.<sup>41</sup> Despite an audit and a regulatory review prior to the merger that returned no issues of concern,<sup>42</sup> by 2001 it was discovered that Young had been involved in fictitious transactions and certified ownership of more than 340,000 cattle when the business actually owned fewer than 20,000 head.<sup>43</sup> Investors, including UPI, and lenders were estimated to have lost \$147 million and \$36 million, respectively.<sup>44</sup> UPI, its officers, and in one case, its directors, were named in lawsuits alleging, in part, that they should have been held accountable for the fraud despite their role as an investor with little involvement in the company's operation.<sup>45</sup> For example, in one suit, a borrower of UPI's credit subsidiary impacted by the fraudulent scheme claimed that the cooperative's officers and directors breached their duties in overseeing the cooperative.<sup>46</sup> The claims did not ultimately result in liability for the directors and officers, but the situation did precipitate a Chapter 11 bankruptcy filing and subsequent reorganization by UPI.<sup>47</sup>*

*Dennis Bolling, UPI's president and chief executive officer from 1989 until 2015,<sup>48</sup> shared his perspective on navigating the complex situation, explaining it was imperative that UPI's management prioritize transparency with the board and keep directors fully informed of the cooperative's strategies and possible actions.<sup>49</sup> When asked what advice about minimizing legal risks he would share with cooperative directors, Bolling said, "In a merger or other business combination, directors should look for independent, third-party assessments to verify financial conditions, outstanding legal matters, and more. Of course, the painful lesson is that you can do this and still have issues, which points to the criticalness of internal controls. Additionally, boards need to understand their bylaws' indemnification clauses and the scope of the director's and officer's insurance. These are not panaceas."<sup>50</sup>*

Another example is discussed in *Chapter 4: Cooperatives, Securities and Other Laws* where despite having hired attorneys and accountants, directors of the Farmers Co-op of Arkansas and Oklahoma, Inc. were found liable for securities law violations.<sup>51</sup>

Sometimes, cooperative directors think they can "recuse their way out of liability" by abstaining from a vote or recording a dissenting vote on an issue that raises concern.<sup>52</sup> However, for a director to use their abstention to avoid liability, they would have to show that they had no role in the board coming to the decision that created an issue.<sup>53</sup> For example, a director cannot simply absolve themselves of liability by abstaining from a

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<sup>41</sup> Olson, *supra* note 38 at 131.

<sup>42</sup> Interview with Dennis Bolling, *supra* note 40.

<sup>43</sup> Olson, *supra* note 38 at 131-132.

<sup>44</sup> *Id.* at 132.

<sup>45</sup> *Id.* at 132; Interview with Dennis Bolling, *supra* note 40.

<sup>46</sup> Interview with Dennis Bolling, *supra* note 40.

<sup>47</sup> *Id.*; Olson, *supra* note 38 at 132.

<sup>48</sup> Olson, *supra* note 38 at 130; Interview with Dennis Bolling, *supra* note 40.

<sup>49</sup> Interview with Dennis Bolling, *supra* note 40.

<sup>50</sup> *Id.*

<sup>51</sup> See *supra* pp. 45-6.

<sup>52</sup> Traxinger, *supra* note 4.

<sup>53</sup> Traxinger, *supra* note 4; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 4.

formal vote if they helped negotiate, structure, advocate for, or otherwise were engaged in the decision-making process for a transaction or issue.<sup>54</sup>

One of the biggest challenges for a cooperative board of directors is oversight of management. The cooperative board can adopt written policies that require management to report certain issues to the board, provide direction to management on which actions they can take without first obtaining board approval, authorize management to make certain expenditures while requiring board approval on others, and spell out other policies and procedures for the cooperative.

It is important to remember that if the board puts policies in place, then they should be periodically reviewed and monitored for compliance. External and internal auditors can assist the cooperative board with this process.

Some state cooperative laws grant or permit the board to delegate some authority to a board committee.<sup>55</sup> Board committees can also be helpful tools in this process and limit the amount of time the full board spends on a certain topic, assuming the board committee reports its findings to the full board. The executive committee is often the board committee tasked with taking action between board meetings if there is an urgent matter. Some states require the executive committee to be elected by the full board.<sup>56</sup> Typically, the cooperative's officers make up the executive committee, which can also include additional directors. The scope and authority of board committees should be clearly defined.<sup>57</sup> For example, it is typical for committees to be restricted from taking action on their own, rather, the committee makes recommendations or reports to the full board.

Throughout this guide, we have encouraged directors to engage with their cooperative's legal counsel to understand their duties in the context of their own cooperative. If the cooperative has an internal or external general counsel, that counsel's client is the cooperative as represented by the board of directors.<sup>58</sup> The counsel's client is not the cooperative's chief executive officer or other employees.<sup>59</sup> In other words, if the cooperative is the attorney's client, the attorney has a duty to the cooperative board.

It is also important for directors to know that when they seek legal advice from the cooperative's attorney, they do so in the context of an attorney-client relationship, which may include characteristics such as attorney-client privilege. However, the cooperative's attorney is not a director's personal attorney and there may be situations where it is advisable for a director to hire their own personal counsel.

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<sup>54</sup> Traxinger, *supra* note 4; FIDUCIARY DUTIES OF THE BOARD OF DIRECTORS, *supra* note 4.

<sup>55</sup> TENN. CODE ANN. §43-16-119; VA. CODE ANN. §13.1-324(e); WIS. STAT. §185.33.

<sup>56</sup> ALASKA STAT. ANN. §10.15.170; N.M. STAT. ANN. §53-4-18; VA. CODE ANN. §13.1-324(e).

<sup>57</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 64.

<sup>58</sup> CORPORATE LAWS COMMITTEE, *supra* note 1 at 49.

<sup>59</sup> *Id.*

## **5.5 Conclusion**

Cooperatives and their directors can use a number of tools to help limit directors' liability exposure. Chief among these tools is each directors' ability to ensure that they act with care in meeting their legal duties. In addition, directors may be protected from liability for certain actions under exculpation provisions, cooperatives may indemnify directors or advance expenses when directors must defend themselves against claims related to their service, and cooperatives can purchase D&O liability insurance to help cover these costs and provide protection to both directors and the cooperative.

[Director Self-Assessment on Following Page.]

## 5.6 Director Self-Assessment

The tools discussed in this chapter can help cooperative directors mitigate the risks inherent in board service. The following checklist can help directors identify the topics they can investigate further to understand how these tools are used in their cooperative.

	Yes	No
<i>I am familiar with the applicable state laws regarding liability and indemnification applicable to serving as a director in my cooperative.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I have reviewed my cooperative's organizing documents to understand whether they contain provisions limiting my personal liability, including an exculpation, indemnification, and/or insurance provision.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I have reviewed materials and information about my cooperative's director's and officer's liability insurance policy.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I understand the procedures that my cooperative uses for audits or assessments for due diligence purposes, but I understand that these steps do not absolve me of responsibility for decision-making.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I am familiar with the cooperative's board policies and procedures.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>I ask questions, speak up when I am unsure and seek advice and counsel when there is not enough information provided, I require more information, or I do not feel that I am meeting my duties.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>Does my cooperative carry director and officer liability insurance coverage?</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>If yes, I am familiar with the amount of director and officer liability insurance coverage provided.</i>	<input type="checkbox"/>	<input type="checkbox"/>
<i>If yes, I am familiar with what the director and officer liability insurance does not cover.</i>	<input type="checkbox"/>	<input type="checkbox"/>

## About the Authors

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