Director Liability: an Overview for Directors of Agricultural Cooperatives

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Americans—even farmers—have always been a litigious people. In 1840, when our country was predominantly rural, the French historian De Tocqueville wrote at length after a tour of the United States about the fascination of the American public with their legal process. Today, litigation continues to increase in our society, and increasingly greater attention is being paid to the actions of directors, particularly in the context of corporate reorganization or financial setbacks.

In the past, agricultural cooperatives were, for the most part, out of the fray. Now cooperatives, including those in California, are venturing into areas which, historically, have a greater potential for litigation. To attract new members, and to enhance the value of membership for existing members, cooperatives offer financial services which traditionally were left to banks or production credit associations. Cooperatives make production loans and, to assist a grower in acquiring new properties, also offer bridge loans and brokerage services. Other cooperatives, particularly processing cooperatives with a large capital base, have closed membership, with the expectation of thereby increasing the value of existing members' equity interests. These are but a few examples of the way cooperatives are changing the way they have traditionally done business in California.

Moreover, when cooperatives in California suffer financial reversals, or changing market forces, they face the same kinds of choices presented to other businesses in similar circumstances: dissolution, bankruptcy, or partaking in some form of merger or consolidation. Many agricultural cooperatives have chosen the latter course in order to pool resources and markets with those of another cooperative or cooperatives in order to remain a viable economic entity.

While these business strategies may make the cooperative a more attractive entity for many growers, they also may involve additional risks, especially in times of economic hardship. The easiest way to eliminate risk, of course, is to get out of business. Obviously, that is an unacceptable course of action; neither management nor the directors of a cooperative, or any other business, can afford to become so preoccupied with legal liability that they become paralyzed as a business entity. Your lawyer's job is to help you minimize those risks while you continue to pursue your business objectives.

In this paper I will review the areas where the potential for personal liability is most likely to arise for the director of a cooperative, what you should be alert to, and how you should deal with the problem in a general sense. As a director, you should know enough about the potential problem areas to enable you to recognize them when you see them. Then seek legal advise tailored to your exact situation.

The focus of this paper is on personal liability—when you may be personally on the hook for something you did in your capacity as a director.

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Fiduciary Duty

A cooperative director is a fiduciary and owes a fiduciary duty to the cooperative and its members. This status of fiduciary signifies a special relationship between a director and the cooperative, characterized by trust and confidence reposed in the director, and by the director's integrity and candor with respect to the cooperative. Whether the duty is attributed to the director's role as an agent for the cooperative or as trustee for its assets, a director has, by virtue of his position, assumed the fiduciary duty to act for the cooperative's benefit.

Duty of Loyalty

As a director, you owe special duties to the cooperative which a mere member does not owe. A member must abide by his or her membership agreement and the bylaws; so must you. A director, however, must also be loyal to the cooperative because that office places you in a position of trust. This duty mandates that directors only consider the best interests of the cooperative and all of its members when making business decisions. When corporate fiduciaries breach their duty of loyalty, they can be held personally liable.

There are three principal areas in which your loyalty is required: the first is to avoid conflicts of interest; the second is to forego corporate opportunities; and the third is not to misappropriate for yourself "inside information" about your cooperative.

Conflicts of Interest. As a director, you must avoid voting on, or participating in, matters as to which you have a conflict of interest. What is a "conflict of interest"? Here is a standard legal definition:

> A conflict of interest between a director and the cooperative arises whenever the director has a material financial interest in a contract or transaction that affects the cooperative, its members, or to which the cooperative is a party.

That is an imperfect definition for directors of a non-profit agricultural cooperative association.

Why? Because unlike the director of a for-profit corporation, who typically just owns stock in it, you not only own an interest in the cooperative (through stock, retains, or capital certificates), but also market your crop through the cooperative. Therefore, you have by definition, a "material financial interest" in virtually every matter that comes before the board concerning the marketing of any commodity that you produce. Does that mean you must disqualify yourself whenever such a matter comes before the board, because the marketing of your crop will be affected by the decision reached by the board? Not in my opinion, although there is scant law on the subject.

One must take into account the special structure of a cooperative; it is comprised of producers who, by law, associate together to market the crops they produce. To that extent "self-interest" is an inherent part of every cooperative, and no director will be without it.

Therefore, in my opinion, no conflict of interest exists unless the director has a financial interest in the matter or transaction before the board which is different from that of other members, or at least other members in the district which you represent. Thus, any transaction which would treat you differently from other members, or at least those in your district, probably creates a conflict of interest. For example, a proposed contract between the cooperative and a processor in which you own a financial interest would present a conflict of interest if your personal interest in the proposed transaction were different from that of any other member. Other examples of typical

conflicts include situations where the director has a financial interest in a company that proposes to supply services or goods to the cooperative, or where the board is asked to approve a loan to a director or any other transaction unique to him.

What do you do when confronted with a potential conflict of interest? You do three things: you make full disclosure to the board of your interest in the proposed transaction; after you have made the disclosure and answered any questions, you offer to excuse yourself from the meeting; and if you stay in the meeting, you abstain from the vote. For the transaction to be approved by the board, it must receive a majority of the votes of the disinterested directors; and it must be just and reasonable to the cooperative at the time it is approved.

This "just and reasonable" requirement still leaves room for the board to be second-guessed and, in the case of the director who has a financial interest in the transaction, still leaves him potentially liable to the cooperative if the transaction should prove unjust or unreasonable. There is a way, however, to avoid this problem: obtain the approval of the membership for the transaction. Of course, going to the membership for a vote is cumbersome, but if the transaction in question is of sufficient importance to the cooperative, it is the prudent course to follow.

In response to this uncertainty regarding directors' liability for breaching their duty of loyalty, corporations have begun inserting provisions into their articles of incorporation or bylaws allowing directors to enter into transactions with the corporation. Courts have generally upheld these provisions. In keeping with this attitude, many state corporate statutes, including California, now include similarly intended "safe harbor" provisions that establish in some manner the rule that a transaction between a director and the corporation is not voidable simply because of the director's interest in it. These safe harbor provisions usually shift the burden of proof to the challenger if the transactions are substantively fair and were approved by informed, disinterested directors. You should consult your counsel as to whether additional provisions in your bylaws would be advantageous for your cooperative.

Nonetheless, you are the person in the best position to know whether a conflict exists, and it is your responsibility under the law to step forward when it happens.

Corporate Opportunities. Your duty of loyalty requires not only that you avoid conflicts of interest, but also that you give up business opportunities that may be of value to the cooperative, unless the board decides not to take advantage of the opportunity. The rule bears repeating:

> As a director, you are precluded from personally taking advantage of business opportunities that would also be of value to the cooperative, unless the cooperative decides not to take advantage of the opportunity.

For example, suppose you have a packing operation and a grower asks you to market his fruit; if the cooperative could also market that fruit, you cannot take advantage of the opportunity unless the board turns it down. Occasionally, the cooperative is unable to take advantage of the opportunity for itself, for example, when the cooperative either is not in a position financially to avail itself of the opportunity, or is prohibited from obtaining the opportunity by a statute or government regulation or by its articles or bylaws. In these circumstances, a prudent director still would not himself take advantage of the opportunity unless the board consents.

What do you do as a director when confronted with an opportunity that may also be of value to the cooperative? You follow the same procedure outlined above for a conflict of interest: you

make full disclosure to the board; you offer to leave the meeting; and you do not vote. You cannot take advantage of the opportunity unless a disinterested majority of the board turns it down. It is important to do this even if you feel that the cooperative will be unable to obtain the opportunity for itself. This will be the best means of shielding yourself from potential liability.

The penalty for a violation of this duty is severe: you give up all the benefits of the transaction, including profits, and are liable in addition to any out-of-pocket damages you may have caused the cooperative.

Inside Information. As a director, you will have access to information that a mere member will not be aware of. Your duty of loyalty extends to this "inside information." You must keep it confidential and may not use it to advance your own personal interests. A director should deal in confidence with all matters involving the cooperative until such time as there has been general public disclosure. It is a breach of the duty of confidentiality and loyalty to the cooperative either directly or indirectly to misappropriate information. Especially in the case of market sensitive information such as financial data or production strategies, a director should not reveal such information to any person or use it to advance the director's personal financial interests.

Duty of Care

In addition to your duty of loyalty, directors are also personally responsible to the membership to be careful. You may be the most loyal director in the state, but that's not enough if you fall asleep at the wheel. In ful-filling your legal responsibilities as a director, you must also behave like a "prudent person." Here is the legal definition of a director's duty of care:

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation, and with such care, *including reasonable inquiry*, as an ordinarily prudent person in a like position would use under similar circumstances.

Let's break this rule down into three practical categories:

Attention to Cooperative Matters. As a director, you need to attend to the business of the cooperative. That means that it is ultimately your responsibility that the business of the cooperative is taken care of. For you to discharge the duty of care in any transaction, you must exercise due diligence. Due diligence is defined as:

> A measure of prudence, activity or attention, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the circumstances, depending on the relative facts of the special case.

To comply, make sure that the items called for in the bylaws (for example, the annual audit) get done. Also, as a general matter, you should attend meetings, learn the basic facts about the business of the cooperative, read the reports submitted to you by your management; seek needed help when a danger signal appears; and adopt the normal habits of diligent behavior, such as keeping informed about the cooperative's activities, reviewing financial statements, and the like.

Delegation of Duties. You are full-time farmers as well as directors; you have your own businesses to run. So what do you do to make sure that the business of the cooperative is taken care

of? You do what every other board of directors does: you hire managers and delegate tasks to them.

Delegation, however, entails certain duties on your part. You are not guarantors of the fidelity of your management, but you may not blindly rely upon them either. Specifically, you must use due diligence in hiring your managers (interview, reference checks, etc.) and in monitoring their on-the-job performance.

You may also rely on professionals—lawyers and accountants—but not blind reliance. You may not sit idly back and passively "trust the expert" with your business. You have a duty—which you may delegate to a com- mittee of directors—to review underlying facts and documents on which an opinion is based and to question the professional about the opinion.

Accountants deserve special emphasis, because they are needed every year for the cooperative's annual audit. The board of directors, and not the management of the cooperative, should be responsible for the selection of the auditors and oversight of the audit. This audit process must not be delegated by the directors to their management; it must be done by the board itself. Most boards appoint an audit or a finance committee to oversee the audit function, and your best directors should be appointed to this committee. Remember, the purpose of an "independent" audit is to obtain an audit of the cooperative's financial affairs which is independent of those who manage them. That is why it is your job—not management's—to select the auditors and oversee the audit process.

Decision-making. As directors, it is your job to make decisions. Some of your decisions will be unprofitable, some will be unwise. The law, however, does not expect you to be perfect, and it takes into account that you will be second-guessed every time a decision you make turns out to be unwise or unprofitable. You are protected against personal liability in such circumstances by what is called the "business judgment rule." This is the rule:

> If a decision made or approved by the board of directors proves to be unwise or unprofitable, the directors do not incur personal liability unless the complaining party can show that the directors were uninformed, acted in bad faith, engaged in fraudulent conduct or were negligent in carrying out their duties.

In short, you are not liable for a bad decision unless you were dishonest, cheated the cooperative, or were careless in your duties. As long as you use due care in arriving at a decision, you are protected. That is a substantial shield against personal liability. Without it, few would ever agree to serve on a board of directors.

There are, however, two instances where you, as a director, are not entitled to the protection of the business judgment rule. First, you are not protected if you had a material financial interest in the transaction, and you did not disclose it and disqualify yourself. If you had a conflict of interest, then you may avoid personal liability for the unprofitable decision only by proving that it was "fair and reasonable" at the time it was made. Good luck, since you will be faced with making this showing against the backdrop of a blown deal.

The other way to lose the protection afforded by the rule is to fail to make reasonable inquiry before voting on the matter. The duty of care imposes a duty upon directors to investigate any wrongdoing they have reason to suspect is taking place within the corporation. You must inform yourself before you vote. In other words, to avail yourself of the protection of the business judgment rule, you must be a prudent and informed director.

Increasingly, directors of cooperatives will be called upon to make decisions which affect competing interests within the membership—decisions which are deemed to be for the good of the cooperative, but which may help or hurt certain individual members more than others. Two of the most heavily litigated areas in recent years have been equity redemption for former members and dealing with members who are in debt and face bank foreclosure. Another area of concern, in which there are many unanswered questions, arises in the context of a cooperative merger or consolidation.

Directors will be called upon to make hard decisions, but the business judgment rule will protect you provided you have no special financial interest in the decision and you make reasonable inquiry into the facts before casting your vote.

Duty of Directors in a Consolidation or Merger Context

Cooperatives are unified in one of two ways. A merger is the combining of two or more cooperatives in which one of the cooperatives survives and the other(s) do not. This can occur as a result of the surviving cooperative purchasing either the stock or the assets of the acquired cooperative. A unification may also take the form of a consolidation. A consolidation occurs when two or more cooperatives combine to form a new cooperative, with none of the "old" cooperatives surviving.

When faced with the opportunity (or threat) of a merger or consolidation, the board of directors is under a duty to act in the best interests of the cooperative. Generally, there are four statutory requirements for a merger or consolidation of cooperatives that the board must follow: (1) a plan of merger or consolidation; (2) approval of the plan by the board of directors of each cooperative; (3) approval of the plan by the members of each cooperative; and (4) filing of the plan with the appropriate state office.

The plan of merger or consolidation is the most important document. It contains the agreements between the merging or consolidating cooperatives, the procedures to carry out the agreements, and the effect of the merger or consolidation on all the members of each cooperative. As a general rule, the plan also contains the names of the cooperatives, the name of the surviving entity, any necessary amendments to the articles of incorporation and bylaws of the surviving cooperative or the articles of incorporation and bylaws of the consolidated cooperative, the composition of the board of directors, the functioning of the merger or consolidated cooperative, a valuation of equities, and a procedure for exchange of equities.

Each cooperative involved in the merger or consolidation generally appoints members to a committee which negotiates the content of the plan. Once the negotiations are completed, the plan must be approved by the board of directors of each cooperative.

After approval by the respective boards, the next step is approval of the plan by the membership of both of the involved cooperatives. In California, the plan *must* be approved by a majority of members entitled to vote; this is called ratification. Furthermore, if the articles or bylaws of the acquiring cooperative need to be amended to authorize additional stock to complete the merger, then the members will be required to vote on those matters as well. Moreover, if any of the cooperatives involved in the merger will be dissolved, a vote of the members is needed to approve the dissolution.

The business judgment rule normally protects all decisions of a board of directors, including

those that result in fundamental corporate changes. However, in merger or consolidation situations of for-profit corporations, courts have found that the interests of the board of directors may diverge from that of the shareholders in that the directors have an inherent interest in perpetuating their positions. This line of cases is arguably applicable to cooperatives as well. Therefore it would be prudent for you to comply strictly with these statutory requirements.

As a director, you should also be mindful of the following issues, which typically arise in any merger or consolidation:

Competing Offers. Whether the board of directors of a California cooperative has a duty to solicit competing offers when presented with an opportunity for a merger or consolidation is not clear. The board of directors is under a general fiduciary duty to the cooperative and must act in its best interests, but it remains to be determined whether or not the law requires the board of a California cooperative to solicit competing offers.

Appraisals. It is also unclear whether the directors of a California cooperative must grant what is called an "appraisal right" to a member who objects to a proposed merger or consolidation. It is a statutory right to be paid the value of his or her shares when a "triggering event" such as a merger or consolidation occurs. This protection is common in business corporation statutes and rare in cooperative statutes. This right assures that any shareholder of a for-profit corporation who does not wish to remain a shareholder after so profound and fundamental a change as a merger or consolidation has taken place will receive the value of his or her shares as determined by a court instead of the merging or consolidating cooperatives.

In California, the cooperative statute does not specifically give dissenters such a right, and there are important differences between a shareholder of a corporation and a member of a cooperative. The question of statutory appraisal rights in a cooperative has not been decided by any California court.

In today's business world, the same market forces that have driven large-scale mergers and acquisitions among corporations also apply to agricultural cooperatives. As a director, you should consider including in the cooperative's articles and bylaws the procedures for approval of a proposed merger or consolidation and whether or not members of the cooperative are entitled to dissenters' rights since the California statute is unclear on the matter. Furthermore, any proposed merger or consolidation and the ensuing negotiations should be well documented in order to avoid any claim of self-interest by any member against you or your fellow directors.

Make Your Record

You should follow procedures which make good management a habit and which record those good habits in case a dispute ever arises:

- Keep complete minutes. Incorporate in them resolutions which briefly explain the basis of the board's decision on important questions, and, in doing so, show that reasonable inquiry was made by the board before it acted. Even if no action on a subject was taken, the minutes should reflect, if possible, that a conscious decision not to take action was made, and the reasons for that decision. Where conflicts of interest arise, have the minutes show that the appropriate procedures were followed.

  As a director, to prevent liability for breach of this duty, you should demand from your managers that you receive advance notice of agenda items and that background information

be circulated before the meeting for you to review. If the subject is confidential and management fears a "leak" by an untrustworthy director, at a minimum form a subcommittee of trustworthy directors to whom the task may be delegated and the information shared in confidence. Note that formation of a subcommittee is an action which must be taken by a majority of the full board, including the untrustworthy director, at a valid meeting.

- Never make important decisions in a social setting or at a brief meeting. The minutes should show that the decision received a thorough investigation before it was made.
- Hire a good manager and pay him well.

Some Options to Consider

Directors' liability insurance is expensive and difficult to obtain. For that reason many cooperatives do not carry such insurance. There is, however, an alternative to insurance which, in certain circumstances, makes the financial resources of the cooperative available to the director who has been sued. Under California law, the board itself has the inherent power, after a director has been sued, to advance his costs of defense and to indemnify him for any settlement or judgment if the director acted in good faith, in a manner believed to be in the best interests of the cooperative, and as a "prudent person" (Cal. Corp. Code 317). Under certain circumstances, prior court approval is also required for indemnification. Any funds used for that purpose, of course, would come from the cooperative itself.

But the board's inherent power to indemnify directors and advance their legal costs has significant limitations, unless the cooperative acts to expand the board's power to indemnify its directors by including in its articles of incorporation a provision authorizing indemnification "to the fullest extent permitted under California law." Your cooperative should explore whether it makes sense to adopt this provision. You should consult your legal counsel for a complete explanation of its ramifications. You should also consider entering into contracts with your directors which require the advancement of expenses as well as indemnification to the maximum extent permitted by applicable law. Again consult your counsel.

The cooperative may also adopt a provision in its articles of incorporation which limits the personal liability of directors for breach of a director's duty of care to the cooperative or its members. By adopting the following provision,

> The liability to the directors of the cooperative for monetary damages shall be eliminated to the fullest extent permitted by California law,

the cooperative eliminates the personal liability of its directors for monetary damages where the director has breached his duty of care to the cooperative, except where the director engaged in "intentional misconduct," was "reckless" or fell into an "unexcused pattern of inattention" to his duties, acted in bad faith contrary to the best interest of the cooperative, "derived an improper personal benefit" from a transaction, or engaged in similar misconduct (Cal. Corp. Code 204[10]). Your cooperative should also consider adopting this provision. (Keep in mind that the cooperative cannot indemnify a director for any of those specified "bad acts.")

Both of these protective provisions are direct responses by the California legislature to the increasing litigation involving directors of corporations generally. Whether your cooperative should adopt them is a matter to be addressed in the first instance by the board, and

subsequently by the membership, after consultation with legal counsel. Many California cooperatives have adopted them, in recognition of the increased risk of litigation that confronts directors in today's business climate.