BOARD OF DIRECTORS' FIDUCIARY DUTIES: ARE THEY COMPROMISED IN AGRICULTURAL COOPERATIVES?

INTRODUCTION

The modern day American Farmer who accepts the responsibility of service on the board of directors of an agricultural cooperative encounters numerous challenges. In most respects, agricultural cooperative directors face the same legal dilemmas and issues as their corporate counterpart. However, cooperative directors face additional hardships and problems.

Conflict of interest is a greater problem for the cooperative director. This is because the cooperative director holds the status of director and member simultaneously. Actions of the board ultimately determine the overall management character of the cooperative.[1] Essentially, a cooperative director has more at stake than a corporate director because board decisions will directly affect his/her livelihood (for instance, crops and individual farming operations). In a corporate setting, the board of directors make decisions that do not carry such personal consequences. In contrast to a corporate director whose stock value might fluctuate from board decisions, a cooperative director makes decisions which affect his/her profits, cash flow, or level of income. Therefore, due to the possibility of losing expected funds, conflict of interest is heightened for the cooperative director.

A cooperative director might encounter numerous conflict of interest issues during an impending dissolution of a cooperative. Some of these issues include: What is the duty of care owed by a cooperative's directors? Could a director be held personally liable for the harm suffered by the cooperative's creditors due to the director/member's deci-

[1] Ron E. Deiter et al., *Directors and Managers in* COOPERATIVES IN AGRICULTURE 320, 326 (David Cobia ed., 1989).

sion? Could a director assert the business judgement rule defense and thus be absolved from personal liability for non-payment to creditors?

An initial overview of agricultural cooperatives will put these issues in perspective. This comment, among other things, will look at the legal relationship between the cooperative's directors and its creditors. Furthermore, this comment will illustrate the responsibilities of agricultural cooperative directors.

I. The Function and Structure of the Agricultural Cooperative

A. *Historical Background*

Agricultural cooperatives have developed into an important part of this country's free enterprise system. Benjamin Franklin opened what is considered the first American cooperative enterprise, a mutual fire fighting company, in 1735.[2] Much of the credit for developing the cooperative idea into a successful organization goes to the Rochdale Society of Equitable Pioneers.[3] This group of textile workers, victimized by the Industrial Revolution, sought to supply their members with the necessities of life at affordable prices.[4] The cooperative principles adopted by the Rochdale pioneers later became the foundation upon which all successful cooperatives are based. As one author commented on the first meeting of the Rochdale Pioneers, "From this moment of great uncertainty evolved the principles and practices that have guided cooperative development in this country to where it is today."[5] The cooperative is a unique business enterprise in the form of a corporation or association, organized to render economic services, without gain to itself, to shareholders or members who own and control it.[6] The objective is to provide producers with marketing services or to supply them with needed commodities at lower costs.[7] The cooperative

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[2] Katherine J. Sedo, *The Application of Securities Laws to Cooperatives: A Call for Equal Treatment for Nonagricultural Cooperatives*, 46 DRAKE L. REV. 259, 261 (1997).

[3] Wendy Moser, *Selective Issues Facing Cooperatives: Can the Customer Continue to Be the Company?*, 31 S.D. L. REV. 394, 395 (1986).

[4] *Id.*

[5] Randall E. Torgerson, *Cooperative Principles That Cannot Be Ignored*, *in* AMERICAN COOPERATION 1985, 131, 131 (Mary Kay Bidlack ed., 1985).

[6] United Grocers, Ltd. v. United States, 186 F. Supp. 724, 733 (N.D. Cal. 1960).

[7] Mary Beth Matthews, *Recent Developments in the Law Regarding Agricultural Cooperatives*, 68 N.D. L. REV. 273, 273 (1992).

structure allows a group to accomplish that which they could not ordinarily achieve individually.

> In the broadest sense, a cooperative is an economic association for self-help. In a practical sense, it is a voluntary organization of people with a common interest, operated along democratic lines for the purpose of providing services at cost to its members and other patrons, who supply both capital and business.[8]

Today, cooperatives are evident throughout America's agricultural industry. Proponents have asserted that the only efficient processing and marketing organization readily available to the modern farmer is the cooperative.[9] For example, Land O' Lakes Butter, Sunkist Oranges, Sun-Maid Raisins, Ocean Spray Cranberries, and Welch's Grape Juice are familiar products of agriculture cooperatives.[10]

B. Democratic Control

Agricultural cooperatives enable individual farmers to exert more control over the prices at which their agricultural commodities are sold.[11] This also permits a relationship with consumers.[12] Thus, farmers, through their cooperatives, have been able to perform a better service for the public and to obtain a greater return for their service.[13] Cooperatives enable the individual farmer to bypass the middleman and thereby reap greater returns.[14] This is accomplished by allowing individual farmers to form a group, or cooperative, and sell directly to the consumer. Cooperatives also purchase supplies for individual farmers at lower prices.[15] Farmer cooperatives handle meats, groceries, feed, petroleum, fertilizer, seeds, building materials, farm machinery or equipment, and sprays and dusts.[16]

Farmers invest money in the cooperative by paying a membership fee to join.[17] This initial investment is a form of internal equity capi-

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[8] LYMAN S. HULBERT, LEGAL PHASES OF FARMER COOPERATIVES 2 (1976).

[9] H.H. Bakken, *General Principals and Problems of Cooperatives: An Introduction*, 1954 WIS. L. REV. 533, 548 (1954).

[10] MOSER, *supra* note 3, at 397.

[11] *Id.* at 396.

[12] ECONOMICS, STATISTICS, & COOPERATIVE SERVICES, U.S. DEPT. OF AGRIC., REP. NO. 9, AGRICULTURAL COOPERATIVE; CHALLENGES AND STRATEGIES 19 (1979) (hereinafter ECONOMICS, STATISTICS, & COOPERATIVE SERVICES).

[13] HULBERT, *supra* note 8, at 16.

[14] ECONOMICS, STATISTICS, & COOPERATIVE SERVICES, *supra* note 12.

[15] *Id.*

[16] ROY, ET. AL., COOPERATIVES: TODAY AND TOMORROW 138 (1964).

[17] Kenneth A. Nielsen, *Generating Capital at a Reasonable Cost: The Farmland*

tal.[18] A study conducted by the Farmer Cooperative Service disclosed the following sources of equity capital in farmer cooperatives: stock equities totaled 44.8%, non-stock equities equaled 42.9%, unallocated reserves were 11%, and all others were 1.3%.[19] "The organization of stock cooperatives involves the subscription of common and preferred stock."[20] Approximately 78% of farmer cooperatives in the United States are established on a stock basis, while about 22% are organized on a non-stock basis.[21] "Profits over and above the cost of doing business are distributed each year in proportion to how much each member uses the cooperative's services."[22]

Cooperatives have been criticized as taking on too much debt and "utilizing leverage to the greatest extent possible."[23] As long as the earning powers of the assets are steady and sufficient to support a highly levered position, no dilemma exists.[24] However, when the economic environment becomes unstable, leverage must be reduced.[25]

Democratic control is a key principle of today's cooperative system, just as it was in the formation of early cooperatives.[26] Essentially, each member is treated equally, and the organization is controlled by consensus. Governance and decision-making authority are determined and delegated according to democratic principles.[27] Significantly, democratic control means one vote per member, regardless of the number of shares or amount of equity owned.[28]

On occasion, specific factors warrant a departure from one-member, one-vote procedures; however, democratic control is the rule rather than the exception.[29] For example, a South Dakota court held that a cooperative's articles or bylaws could authorize deviation from the

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Experience in AMERICAN COOPERATION 1985, 287, 291 (Mary Kay Bidlack ed., 1985).

[18] ROY, *supra* note 16, at 326.

[19] *Id.* at 330.

[20] *Id.*

[21] *Id.*

[22] Brad D. Claiborn, *An Orientation to the Banks for Cooperatives*, in AMERICAN COOPERATION 1985, 271, 271 (Mary Kay Bidlack ed., 1985).

[23] NIELSEN, *supra* note 17, at 292.

[24] *Id.*

[25] *Id.*

[26] Sedo, *supra* note 2.

[27] RURAL BUSINESS-COOPERATIVE SERVICE, U.S. DEPT. OF AGRIC., RESEARCH REP. NO. 156, VOTING AND REPRESENTATION SYSTEMS IN AGRICULTURAL COOPERATIVES 1-2 (1997).

[28] Sedo, *supra* note 2.

[29] VOTING AND REPRESENTATION SYSTEMS IN AGRICULTURAL COOPERATIVES, *supra* note 27, at 3.

one-person, one-vote concept.[30] Although the bylaws set no particular method of voting, the court held that only one vote per family was permitted.[31] In another case, a Washington court held that the promoter of a housing cooperative could subscribe to unsold shares but was not entitled to more than one vote. Thus, any shareholder holding multiple shares still had only one vote.[32]

C. Service at Cost

Another difference between the cooperative and a corporation is its purpose. A cooperative's objective is to provide a service to its user-owners at the lowest possible cost, rather than to generate a profit for investors.[33] This "service at cost" is intended to enhance the profitability of the members' own operation.[34] This emphasis on providing services at cost to members not only replaces the normal corporate profit objective, but also renders a cooperative unsuitable to outside investors seeking dividends or consequential allowances based on earnings growth. Thus, to survive, cooperatives must generate net margins (gross income from all sources minus all allowable expenses)[35] sufficient to cover costs and meet ongoing capital needs.[36]

No feature of cooperatives has been the subject of more scrutiny than service at cost.[37] All businesses, even cooperatives, require some kind of profit. One author contends that the "emphasis on 'non-profit' is not in keeping with the times and has led to many cooperatives' downfall."[38] From 1984 to 1989 agriculture encountered the worst depression since the 1930s.[39] Although most areas of agriculture have prospered, some industries, such as the citrus industry, have been plagued with below average prices.[40]

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[30] Horn v. Kaupp, 147 N.W.2d. 607, 608 (S.D. 1967).

[31] *Id.*

[32] Leavell v. Nelson, 387 P.2d. 82, 85 (Wash. 1963).

[33] Torgerson, *supra* note 5, at 133.

[34] *Id.* at 135.

[35] DOUGLAS FEE ET AL, U.S. DEPT. OF AGRIC., REP. NO. 34, COOPERATIVE INFORMATION REPORT, DIRECTOR LIABILITY IN COOPERATIVES 36 (1999).

[36] Torgerson, *supra* note 5.

[37] *Id.* at 135.

[38] *Id.*

[39] Maxey D. Love, Jr., *A Reflection on Cooperatives Based on Perspectives Established Over Time* (visited Sept. 9, 1999) <http://www.NLFC.org>.

[40] *Id.*

D. Distribution of Income Based on Patronage

Another feature of the agricultural cooperative is that it is a user-owned (patron) and user-controlled (member) business. According to one author, "A major source of difficulty in fitting the farm cooperative . . . into the same legal mold as its counterpart in business conducted solely for profit is the dual relationship of the patron member to the enterprise. He is both proprietor and one of the vendors with whom the cooperative transacts the bulk of its business."[41] Patrons are those who do business with a cooperative, whether by selling inputs or by purchasing goods and services.[42] They also are regarded as members of the association;[43] however, they share in its profits only to the extent they do business with it.[44] Members of a vital and responsive cooperative usually display a much greater and more active interest in their organization than do stockholders of a corporation.[45]

E. Legal Structure and Organization of Agricultural Cooperatives

Cooperatives and corporations are forms of business organizations.[46] In addition, corporate law usually supplements cooperative statutes either impliedly or expressly.[47] A cooperative, like any other business enterprise, must display financial responsibility to induce the extension of credit for a common venture.[48] In fact, numerous traditional attributes of the profit corporation carry over to cooperatives.[49] Courts and legal scholars regularly resort to corporate analogy when no pertinent case law is available to address questions and dilemmas regarding cooperatives.[50] Cooperatives are simply a species of the corporation, and liability for mismanagement flows from the myriad rules that corpora-

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[41] Note, *Legal Aspects of Cooperative Organizational Structure*, 27 IND. L.J. 353, 377-378 (1952).

[42] David Barton, *What is a Cooperative?*, in COOPERATIVE IN AGRICULTURE 12 (David Cobia ed., 1989).

[43] Robert P. Carlisle, Note, Carter & Co. v. Unites States; *The Federal Circuit Finds the Meaning of Subchapter T to be less than Cooperative*, 47 OHIO ST. L.J. 565, 573 (1986).

[44] Robert C. Guenzel, *The Relationship Between Cooperatives and Their Members in Litigation*, 21 S.D. L. REV. 651, 651 (1976).

[45] Bakken *supra* note 9, at 548.

[46] *Id.*

[47] Matthews, *supra* note 7, at 275.

[48] *Supra*, note 41, at 395.

[49] Matthews, *supra* note 7, at 275.

[50] Douglas Fee & Allan C. Hoberg, *Potential Liability of Directors of Agricultural Cooperatives*, 37:60 ARK. L.REV. 36 (1999).

tions generally govern.[51]

F. State Statutory Requirements

Each state (and the District of Columbia) has at least one statute or set of legislative provisions authorizing the formation of agricultural cooperatives.[52] In fact, numerous states have two sets of legislative provisions: one statue for general cooperatives and a second statute for agricultural marketing cooperatives.[53] With so many statutory provisions, it is difficult to make any uniform characterization of state regulations. Generally, however, only corporation laws that are consistent with a state's cooperative statues will apply to cooperatives.[54]

II. THE COOPERATIVE DIRECTOR AND CONFLICTS OF INTEREST

A. Elements of the Cooperative Director and Conflicts of Interest

A member's level of responsibility for a cooperative's functions and procedures varies depending on the size of the association. In a small organization, individual members share most of the responsibilities of the cooperative's operation.[55] In larger associations, these functions are, to a greater extent, carried on by a board of directors.[56]

The board of directors is elected by the membership and is responsible for the overall management and operation of the cooperative's business. Essentially, cooperative directors perform the same function as corporate directors,[57] and "[t]hese similarities have resulted in the ready application by the courts of the principles of corporate law to cases involving cooperatives and their directors."[58]

Board membership generally is restricted to members of the particular cooperative.[59] States generally set a minimum of three to five directors.[60] However, five to nine directors seems to be the most effec-

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[51] Guenzel, *supra* note 44, at 641.

[52] MATTHEW BENDER, AGRICULTURAL LAW, ON AGRICULTURAL COOPERATIVES, DIRECTORS AND OFFICERS, VOL. 14, § 131.01[1] (1999) [hereinafter NEIL E. HARL].

[53] *Id.*

[54] *Id.* at § 131.7.

[55] Bakken, *supra* note 9, at 538.

[56] *Id.*

[57] NEIL E. HARL, *supra* note 52, at § 131.04.

[58] Fee & Hoberg, *supra* note 50, at 61.

[59] Bakken, *supra* note 9, at 539.

[60] *Id.*

tive working group.[61] Some larger associations choose to have even greater numbers of board members, despite the obvious potential for large, cumbersome committees.[62]

B. Fiduciary Duties

As in corporations, cooperatives' directors owe fiduciary obligations to members and others.[63] A fiduciary is defined as a person with a duty, created by his/her own undertaking, to act primarily for the benefit of another in matters connected with the undertaking.[64] Thus, the board owes certain obligations to the cooperative,[65] its creditors, and its members. These include the duty to obey the articles and bylaws and the responsibility to treat members impartially.[66] Safeguarding the cash assets of the cooperative is likely a responsibility shared by both officers and directors in most cooperatives.

As with corporate directors, the fiduciary relationship is "characterized by trust and confidence in the director and by the director's integrity and candor toward the cooperative."[67] Fiduciary duties are usually imposed upon the corporate/cooperative board, and not on the corporate entity itself.[68] Members motivated to board service by the honor associated with the position should be mindful that such service carries with it significant legal ramifications.

C. Duties of Obedience, Loyalty, and Care

"It is an elementary principle of corporate law that directors of corporations have three duties: obedience, loyalty[,] and care. Cooperative directors have the same duties."[69] To satisfy the duty of obedience, a director must comply with the incorporating statutes; articles of incorporation; bylaws; and local, state, and federal laws.[70] Regarding the duties of loyalty and care, the director must not only act in good faith, but also with diligence, care, and skill.[71]

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61 *Id.*
62 *Id.*
63 Matthews, *supra* note 7, at 275.
64 FEE, *supra* note 35, at 35.
65 Matthews, *supra* note 7, at 276.
66 *Id.* at 275.
67 Fee & Hoberg, *supra* note 50, at 63.
68 Matthews, *supra* note 7, at 283.
69 NEIL E. HARL, *supra* note 52, at §§ 131.05 & 131.50.
70 *Id.*
71 *Id.*

The director's duty of loyalty is the most often litigated of the fiduciary duties.[72] Among other things, it encompasses a duty to refrain from conflicts of interest.[73] "These duties are owed to all members and shareholders, to the cooperatives as an entity, to other directors, and may extend to the cooperative's general creditors."[74] Furthermore, most states impose the same duty of care on cooperative directors that is imposed on corporate directors.[75]

III. Potential Conflicts

A conflict of interest is "a clash between the personal pecuniary interest of the fiduciary/director and the interest of the cooperative to which the fiduciary duty of undivided loyalty is owed."[76] As early as 1846, The Supreme Court of the United States explained the rule against conflicts:

> The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity. In this *conflict of interest*, the law wisely interposes. It acts not on the possibility, that, in some case, the sense of that duty may prevail over the motives of self interest, but it provides against the probability in many cases, and the danger in all cases, that dictates of self-interest will exercise a predominant influence, and supersede that of duty.[77]

If a director's official conduct furthers an interest adverse to the association (or to others) the act will be subjected to the utmost scrutiny.[78] Similarly, a director's self-dealing is highly suspect.

Where any self-dealing is evident, the burden is placed upon the interested director to establish his/her good faith and the fairness of the transaction to the organization.[79] In general, a conflict exists and the fiduciary duty of loyalty is breached, if directors use their position or the cooperative's assets for personal gain.[80] Further, it has been held that where directors are aware that a conflict of interest exists, they have an obligation to disclose it to the appropriate authority.[81]

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72 Fee & Hoberg, *supra* note 50, at 63.
73 *Id.*
74 *Id.*
75 Parish v. Maryland, 277 A.2d 19, 48 (Md. Ct. App. 1971).
76 FEE, *supra* note 35, at 34.
77 HULBERT, *supra* note 8, at 134.
78 *Id.* at 126-127.
79 Pepper v. Litton, 308 U.S. 295, 295 (1939).
80 Fee & Hoberg, *supra* note 50, at 65.
81 Berkman v. Rust Craft Greeting Cards, Inc., 454 F. Supp. 787, 793 (S.D.N.Y.

A. Cooperative Capitalization Problems

Cooperatives face the same capital needs as any business organization, but often find the satisfaction of those needs to be more onerous than for private corporations.[82] The capital assets of a cooperative represent contributions of the members and shareholders, and are owed to them after creditors' claims are liquidated.[83] The capital of any business could be classified as equity or credit.[84] For most cooperatives, large amounts of equity capital are difficult to obtain from private investors.[85] Instead, cooperatives must rely on their own members. Outside investors are deterred by the limited return on investment and the one-member, one-vote requirements.[86]

On the other hand, patrons, acting in compliance with the organization's bylaws or marketing contracts, have an obligation to invest in the cooperative.[87] From these limited sources,"[e]nough equity capital must be provided on a permanent basis to insure that the cooperative will be sufficiently free from creditors' claims to perform the needed services."[88]

Directors of an undercapitalized cooperative face an inherent conflict of interest, and creditors face additional risk where such a situation exists. Creditors face an unreasonable risk of loss since upon liquidation, capital is utilized by directors to settle claims against the cooperative.[89] Thus, undercapitalization could prove to be injurious to creditors due to inadequate funds.

B. Members' Redemption Rights

Redemption rights are another unique characteristic of the cooperative association that can raise conflict of interest problems. Redemption refers to the right of a debtor (the cooperative) to repurchase evidences of a debt by paying its value to the holder (cooperative members).[90] One commentator has observed that, "Cooperative mem-

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[82] Bakken, *supra* note 9, at 541.

[83] FEE, *supra* note 35, at 33.

[84] ROY, *supra* note 16, at 329.

[85] Bakken, *supra* note 9, at 543.

[86] Sedo, *supra* note 2, at 262.

[87] David W. Dewey, *Cooperatives: Identifying and Clarifying the Responsibilities*, 23 S.D. L. REV. 536, 537 (1978).

[88] ROY, *supra* note 16, at 330.

[89] *Id.* at 392.

[90] BLACK'S LAW DICTIONARY 1278 (6th ed. 1990).

bers recoup the bulk of their investment not by sale [of shares] in a market, but by redemption of the shares or equity certificates by the cooperative."[91] The timing and the amount of redemption are decisions within the discretion of the board of directors, based on available assets.[92] A members' investment is called patronage retain, and it is evidenced by common or preferred stock, or by an equity certificate or book entry that is established for that particular member.[93] It should be noted, however, that before distributing dividends, directors must set aside sufficient reserves for future financing.[94] Moreover, there are instances when a member should not expect redemption. For instance, redemption may be delayed by poor performance on the member's part.[95] Also, those cooperatives that continuously offer favorable prices give immediate benefits to patrons.[96] The resulting narrow margins do not generate adequate funds to meet cash flow or redemption requirements.[97] This results in delayed redemption, or possibly a lack thereof.

A serious flaw in the performance of cooperatives is the failure to redeem equity of over-invested members[98] and secure more funds from those not providing their proper share.[99] Furthermore, failure to redeem equity also creates "a negative image . . . of cooperatives, their directors, and management on the part of [the] general public, farmers, and even some members."[100]

The dual demands of cooperative financing and member requests for redemption often conflict.[101] Since cooperative directors are usually members as well, assuring redemption of their equitable interests in the cooperative might be considered a self-interested transaction. When the cooperative is under financial strain, a board decision to redeem will necessarily harm the cooperative's creditors. Such a redemption will only serve to further weaken the cooperative's financial position, at the expense of its creditors.

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[91] Matthews, *supra* note 7, at 275.

[92] *Id.*

[93] *Id.* at 274.

[94] Moser, *supra* note 3, at 398.

[95] David W. Cobia et al., *Equity Redemption* in COOPERATIVES IN AGRICULTURE 271 (David Cobia ed., 1989).

[96] *Id.*

[97] *Id.*

[98] *Id.* at 267.

[99] *Id.* at 268.

[100] *Id.* at 269.

[101] Fee & Hoberg, *supra* note 50, at 94.

C. Insolvency and Preferential Treatment

There are various approaches to securing protection for creditors. However, cooperatives exhibit a strong propensity to provide only a minimal margin of security to their creditors.[102] Accordingly, there is a high probability that on the eve of dissolution,[103] the creditors may not receive the full payment owed to them. The effect of this policy may subvert those goals sought to be advanced by not making payments and thus discouraging the extension of credit.[104] This would hinder the primary goals of the cooperative: to survive, expand, and grow.

Banks loan money to cooperatives for such purposes as financing accounts receivable, inventories, construction, expansion of facilities, and purchasing land, buildings, and equipment.[105] Banks look at various factors when contemplating a loan request and evaluating a cooperative's stability:

> First, [m]anagement. A prerequisite for a sound loan is capable directorship and competent management. This factor is extremely important. Second, [r]epayment [a]bility. Generally, the cooperative's ability to repay the loan should be adequate to meet all obligations, provide a margin for contingencies, and maintain adequate working capital. Third [,] [f]inancial [c]ondition and [o]perations. A borrower must demonstrate a sound financial condition. Several indicators are examined before making this determination. Fourth, [e]conomic [s]ituation. A sound loan can be made only after a cooperative's economic viability (ability to operate under normal or favorable conditions) is analyzed. When determining a cooperative's economic situation, the bank will look at several factors. These may include: basic need for a cooperative's goods or services[,] member support[,] competition[,] industry trends[,] [and] legal climate in which a cooperative operates[.] The fifth and final credit factor is [l]oan [p]urpose. The loan being requested should have a direct bearing on the provision of goods or services to a cooperative's members. Therefore, the cooperative must define a specific purpose for the loan, and the loan amount requested must be sufficient to accomplish that purpose.[106]

Often, cooperative charters authorize, and articles or bylaws adopt, a debt limitation.[107] Legislation may also impose personal responsibility on directors for exceeding the cooperative's debt limitation, "thus providing some modicum of protection to unwary creditors while limiting

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[102] Note, *supra* note 41, at 396.
[103] FEE, *supra* note 35, at 35.
[104] Note, *supra* note 41, at 396.
[105] Claiborn, *supra* note 22, at 273.
[106] *Id.* at 274.
[107] Note, *supra* note 41, at 397.

the risks assumed by the association's patrons."[108]

Another related problem common to cooperatives approaching insolvency involves preferential treatment of particular favored creditors to the serious detriment of others. Insolvency occurs when any business: "[H]as reached a point in its affairs when its directors know that it cannot pay its debts, and, for lack of sustenance, cannot longer do business . . . it is then, to all intents and purposes, insolvent."[109]

Moreover, preference means a transfer or encumbrance of corporate assets made while the corporation is insolvent or on the verge of insolvency. The preference enables a specific creditor to recover a greater percentage of debt than general creditors of the corporation with otherwise similarly secured interests.[110] It is well established that directors of an insolvent cooperative/corporation are not permitted to satisfy their claims against the cooperative/corporation in preference to the demands of the general creditors.[111]

Case law points to the consequences of preferential treatment when a corporation's board members are also its creditors. Although these decisions have involved corporate boards rather than cooperative boards, they would probably apply to cooperatives under similar circumstances.[112] In *Taylor v. Mitchell*, an action was brought by creditors of the corporation against the defendant corporation and its board. The defendants, other than the corporation, were, and for a long period of time prior thereto had been, directors of the corporation.[113] The directors, being the creditors, mortgaged corporate property to themselves to secure their debt.[114] The corporation was insolvent at the time. The court held:

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[108] *See* Federal Chemical Co. v. Paddock, 264 Ky. 338, 340 (1936); Lockport Coop. Dairy Ass'n v. Buchner, 129 Misc. 73, 74 (N.Y. Sup. Ct. 1925). These decisions also emphasize the significance of protection of creditors by revealing that the cooperative involved had no capital and conducted its business entirely on borrowed money.

[109] Stuart v. Larson, 298 F. 223, 226 (8th Cir. 1924).

[110] Snyder Electric Co. v. Fleming, 305 N.W.2d. 863, 869 (Minn. 1981).

[111] Darling & Co. v. F. C. Petri, 138 Kan. 666, 670 (Kan. Sup. Ct. 1933). The plaintiff supplied fertilizer to a cooperative on a consignment basis. The defendant, a director of the cooperative, loaned it money and had taken a note in return. He surrendered his note and claim in exchange for fertilizer immediately prior to the cooperative's insolvency. Recovery against the defendant was sustained on the theory that he was in effect a trustee, with notice of the terms of the contract, and that as against the creditors of the consignee, the consignor's rights are protected.

[112] LEON GAROYAN & PAUL O. MOHN, U.CA., DEP'T. OF AGRIC., PUB. NO. 4060, THE BOARD OF DIRECTORS OF COOPERATIVES 25 (1985).

[113] Taylor v. Mitchell, 80 Minn. 492; 83 N.W. 418, 420 (1900).

[114] *Id.*

> When the corporation is insolvent, its directors who are its creditors cannot secure to themselves any advantage or preference over other creditors. They cannot thus take advantage of their fiduciary relation, and deal directly with themselves, to the injury of others in equal right. If they do, equity will set aside the transaction at the suit of creditors, without reference to the question of any actual fraudulent intent on the part of the directors, for the right [of] the creditors does not depend upon fraud in fact, but upon the violation of the fiduciary relation of the directors.[115]

It is plain to see that a director occupies a fiduciary position vis-a-vis creditors.[116] Thus, it is inequitable for directors to gain personal advantage via their position, knowledge of conditions, and power to act for the corporation.[117] Directors should not be permitted to protect their own claims to the detriment of others.[118] This is especially true when all unsecured debts of the corporation are equally at peril and all cannot be paid.[119] Because they have better resources for monitoring the corporation's condition than do other creditors, fiduciary directors may not treat themselves, at the expense of other bonafide creditors, to a preference in collecting their business debts.[120]

Any contract between a corporation or cooperative and a director that embodies preferential terms or conditions puts the director in a position of liability.[121] Additionally, the corporation/cooperative retains the right to bring suit against directors to annul a contract as voidable due to the director's unlawful personal interest.[122] Directors are personally liable when they cause or are responsible for the organization's violation of the legal rights of others, such as by the misapplication of funds or by deceit.[123] By the same token, directors can be held personally liable for damages that they have inflicted upon third party creditors.

D. Transactions Between the Director and the Cooperatives

Conflicts of interest also arise in business transactions between the director and the cooperative. The board is responsible for safeguarding

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115 *Id.*

116 Stuart v. Larson, 298 F. 223, 227 (8th Cir. 1924).

117 Farmers Co-Operative Assoc. v. Kotz, 222 Minn. 153, 158 (1946).

118 *Id.* at 154.

119 *Id.* at 153.

120 B & S Rigging & Erection, Inc, v. Wydella, 353 N.W.2d 163, 166 (Minn. Ct. App. 1984).

121 GAROYAN & MOHN, *supra* note 112, at 27.

122 HULBERT, *supra* note 8, at 134.

123 *Id.* at 135.

assets of the corporation against preferential treatment to shareholders or members at the creditor's expense.[124] Moreover, when directors deal among themselves directly, the transactions are subject to the closest scrutiny, under the most searching light of truth, and "must be characterized by absolute good faith."[125] One case held that:

> [C]ontracts and transactions between individuals and corporations of which they are directors or officers, which are unfair, in which the individuals have secured an undue or unjust advantage, in which an antagonism between the interest of the individuals and the duty of the officials has resulted in the triumph of the former, are voidable at the option of the corporation, its creditors or stockholders.[126]

Any self-interested transaction the director makes in his/her official capacity is subject to strict inquiry to ensure fairness.

E. The Business Judgment Rule

A cooperative director is required to make numerous decisions regarding the organization.[127] Despite all reasonable precautions, error is bound to occur.[128] As a result the business judgment rule has developed.[129] If the director's decision was not made on the basis of reasonable information or without any rational basis whatsoever, liability will be incurred.[130] Therefore, directors must exercise informed and purposeful vigilance in carrying out their responsibilities to the cooperative.[131]

In the performance of their management functions, directors might have to make certain decisions that prove to be unpopular and/or disadvantageous to the cooperative.[132] The business judgment rule is a defense that protects them from personal liability, provided the challenged conduct satisfies the directors' duty of care.[133] It is premised on the following: Those in management positions are best to judge whether a certain act or transaction benefits the association, and establishes a presumption that directors' decisions are based upon sound

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124 *Id.* at 29.

125 Stuart v. Larson, 298 F. 223, 228 (8th Cir. 1924).

126 *Id.*

127 Fee & Hoberg, *supra* note 50, at 68.

128 *Id.*

129 *Id.*

130 *Id.* at 69.

131 *Id.* at 118.

132 NEIL E. HARL, *supra* note 52, at § 131.64.

133 *Id.*

business judgement.[134] This defense enables the cooperative director to act without fear of personal liability. Under this rule, a director is not liable for a mistake in business if he believed it to be in the best interest of the association, and no conflict of interest existed.[135] As long as the transaction or decision reasonably appears to have been made with due care and in good faith,[136] the directors will be immune from liability.

Occasionally, the business judgment rule will not offer protection. Three types of conduct are excepted: self-dealing, lack of knowledge, and personal bias.[137] Regarding lack of knowledge, the business judgment rule will not shield directors from liability when they fail to consider all relevant information and data that was readily available to them when making important decisions.[138] Furthermore, personal bias, or evidence of favoritism by directors during the decision making process, is likewise not protected by the rule.[139] Self-dealing involves a conflict of interest that differs from violation of a director's duty of loyalty in that it requires no material personal interest in a contract or transaction.[140] A mere interest in the decision is sufficient.[141] An Arkansas case illustrates this: The directors accounted for eighty percent of the cooperative's business and were paying themselves eighty percent of the bonuses at the preferred stockholders' expense.[142] The court found that this self-dealing was not protected by the business judgment rule.[143] In view of the constraints against taking special advantage or profiting by the director's position, the director's self-dealing might be considered a breach of fiduciary duty.[144]

An additional limitation of the business judgment rule is that it can only be applied to disinterested directors.[145] For example, in a California case, the directors were all members of the cooperative.[146] As they benefitted from being released from a "deliver or pay obligation,"

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[134] Eldridge v. Tymshare Inc., 186 Cal. App. 3d 767, 776 (Ct. App. 1986).

[135] Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1266 (1989).

[136] Nursing Home Building v. Phoebe De Hart, 13 Wash. App. 489, 535 (1975).

[137] NEIL E. HARL, *supra* note 52, at § 131.65.

[138] *Id.* at §§ 131.03[3] & 131.65.

[139] *Id.* at §§ 131.05[3] & 131.66.

[140] *Id.* at § 131.05[2][a].

[141] *Id.* at § 131.05[3].

[142] Driver v. Producers Cooperative Inc., 233 Ark. 334, 340 (1961).

[143] *Id.* at 340.

[144] Fee & Hoberg, *supra* note 51, at 65.

[145] Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1265 (Ct. App. 1989).

[146] *Id.* at 1265 (1989).

they were considered interested directors. Accordingly they were denied the benefit of the rule as a defense.[147]

IV. Recommendations

The cooperative association has certain noteworthy characteristics that contrast with a corporate entity. For instance, democratic control and the member-patron ownership of the cooperative differ from a corporation. Although a cooperative is unique in some ways, it is, for the most part, very similar to a corporation. Therefore, all things being equal, the board of directors in either a cooperative or corporate setting should be held to identical fiduciary duties. For instance, when a cooperative is undergoing dissolution, the board of directors should not be permitted to use their authoritative positions to excuse themselves from paying unsecured creditors. While few clear indicia of the proper resolution of disputes concerning dissolution of farm cooperatives are to be found, the courts will presumably adhere to the established rules governing ordinary corporations in solving problems.[148] This supports the notion that in such situations, cooperatives must be held to the same standard as a corporation.

Directors assume immense responsibility when they take on their prospective positions of authority. An inherent threat of liability is enough to warrant forethought so as to reduce or avoid serious liabilities. Self-serving acts leave directors vulnerable, however, liability may be avoided by wise decisions.[149] One way that potential sources of liability can be eliminated is to avoid circumstances that create conflicts of interest and create questions of integrity, ethical conduct,[150] and loyalty.

An educational program should be administered by the cooperative for those members contemplating serving on the board of directors. The educator should employ a cautionary approach in an effort to forewarn the individuals about all possible facets of liability regarding the fiduciary position. Thus, if the director's conduct involves wrongdoing or a misfeasance, then the director may be directly liable to the injured party, including the cooperative or a third party.[151] Moreover, the potential director would learn what constitutes responsible conduct in specific situations, and ways to minimize liability when faced with

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147 *Id.*

148 Legal Aspects of Cooperative Organizational Structure, *supra* note 41, at 391.

149 Garoyan & Mohn, *supra* note 112, at 31.

150 *Id.*

151 Fee & Hoberg, *supra* note 50, at 69.

possible conflicts. The organizational objectives of such an educational program would include maintaining financial soundness for the cooperative business organization and achieving its cooperative principles through educated directors.[152]

With respect to the problem of inadequate capitalization, a business should always maintain sufficient capital to satisfy all financial obligations. Obviously, this is not always reasonable or possible. In a 1936 study, one professor asserted:

> Although there had to that date been surprisingly little discussion in the texts and cases concerning the legal consequences of doing business in corporate form with inadequate capital, the law should insist that a business corporation be set up with the capital reasonably adequate for the organization and conduct of a business of the size, nature, and other characteristics of the business in question.[153]

This should hold true for cooperatives as well; the association should have sufficient capital for future liabilities. Although such a system would require the maintanence of additional funds,[154] it would increase the cooperative's ability to acquire credit when needed for its operation.

When a cooperative's board of directors realize the association is in jeopardy of insolvency, then there must be guidelines found in its bylaws. For instance, the bylaws should prohibit any resolution relieving members from their obligations to provide products to the cooperative. Members should not benefit at the expense of creditors who rely on profits to pay the cooperative's debt. Furthermore, the bylaws should also specify a means of notifying creditors about impending insolvency. Lastly, there should be an explanation in the bylaws regarding potential liability of directors who participate in preferential transfers.

CONCLUSION

Cooperatives are essential to today's agricultural system because they provide individual farmers with a means to survive in the competitive marketplace. Those who serve on a cooperative's board of di-

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[152] William J. Nelson, *Training and Educating Management, Directors, Employees, and Members: The Minnesota Experience*, in AMERICAN COOPERATIVE 1985, 183-184 (Mary Kay Bidlack ed., 1985).

[153] WILLIAM L. CARY & MELVIN AARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 182 (1985).

[154] Michelle G. Oleksa, Comment, *Protecting the Power of the PACA Trust: Contemplating the Effects of the Bona Fide Purchaser Defense*, 8 S. J. AGRIC. L. REV. 173, 184 (1998).

rectors face certain risks and potential conflicts of interest of which they should be made aware and which the cooperative, through its institutional structure, should anticipate. In particular, the potential for conflicts appears greatest when the cooperative is in financial turmoil. To minimize such conflicts, bylaws should clearly point out that a fiduciary relationship exists between the cooperative and its creditors. Educational programs should be administered for cooperative members contemplating service on the board of directors. Furthermore, bylaws should provide specific guidelines for the conduct of members and directors upon the threat of insolvency, including provisions for notice to creditors, and prohibitions against preferential treatment for individual members. Such measures would prevent abuses of discretion in vital decisions by board members, preserving harmony within the symbiotic relationship between cooperatives and their creditors.

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