

**DIRECTOR LIABILITY:
AN OVERVIEW FOR
DIRECTORS OF
AGRICULTURAL
COOPERATIVES**

by
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**Center for Cooperatives
University of California, Davis**

THE CENTER FOR COOPERATIVES

WORKING PAPER SERIES

The Working Paper Series is designed to fulfill part of the less formal communications objectives of the Center for Cooperatives. The series presents papers dealing with cooperative issues or topics of interest to cooperative members, employees, elected officials, and others having an interest in cooperatives. Papers in this series express viewpoints and opinions about a fairly broad spectrum of cooperative topics, but are not intended to be finished reports of formalized research by the authors. Some papers are informative only, while others are, in addition provocative. We intend for them to be educational.

Working Papers are published at irregular intervals, reflecting the financial position of the Center, as well as the interests of authors and availability of papers. They are intended to be brief in nature because they most frequently will not be exhaustive of their subject, but no editorial limit is imposed. Likewise, because the papers reflect opinions and viewpoints of the authors, there is only minor editing involved.

We hope the papers contribute to a better understanding of cooperatives, and lead readers to other more comprehensive publications on topics where further information is desired.

Because the mandate from the California Legislature, when it established the Center, intended that research and educational activities include both agricultural and mutual benefit cooperatives, the Working Paper Series may include papers of interest to both sectors. However, at times the emphasis may be stronger with only one of the two cooperative audiences. To help readers to identify the intended orientation, we follow a numbering system that distinguishes the intended audience by major orientation. Though papers are numbered consecutively during each year; those with primarily an agricultural orientation have the suffix A with the number, and those primarily oriented to mutual benefit cooperatives are suffixed by MB.

Leon Garoyan
Director

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by
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DIRECTOR LIABILITY: AN OVERVIEW FOR DIRECTORS OF AGRICULTURAL COOPERATIVES

Stephen Zovickian*

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 takeover battles involving large publicly-traded corporations.

So far, agricultural cooperatives are out of the fray, at least for the most part. But cooperatives, including those in California, are now beginning to venture into areas which, historically, have had a greater potential for litigation. To attract new members, and to enhance the value of membership for existing members, cooperatives are beginning to offer financial services which traditionally were left to banks or production credit associations. Cooperatives are making production loans and, to assist a grower in acquiring new properties, also offering bridge loans and brokerage services. Other cooperatives, particularly processing cooperatives with a large capital base, have closed membership, hoping to increase 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.

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.

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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 advice 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.

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 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.

There are two principal areas in which your loyalty is required: the first is to avoid conflicts of interest; and the second is to forego corporate opportunities.

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 the 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 variety which 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.

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 you not only to avoid conflicts of interest, but also to 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.

What do you do as a director when confronted with an opportunity that would 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.

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.

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 fulfilling 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. Make sure that the items called for in the bylaws (for example, the annual audit) get done.

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 (interviews, 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 committee 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. 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. 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. 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.

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. Where conflicts of interest arise, have the minutes show that the appropriate procedures were followed.

*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.

*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 in-

corporation 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 for 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(II)). 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.

ABOUT THE CENTER FOR COOPERATIVES

The Center for Cooperatives was established by the California Legislature in 1987 as a center in support of research, education, and extension activities to "advance the body of knowledge concerning cooperatives in general and address the needs of California's agricultural and nonagricultural cooperatives..."

The Center's objectives are to promote:

1. **EDUCATION.** The Center offers formal and informal educational programs to those involved in cooperative management and develops teaching materials for all levels of interest.
2. **RESEARCH.** To help the state's cooperatives reach their objectives, research is conducted on economic, social, and technical developments. A practical aspect of this research: the provision of competitive research grants, and studies for government agencies on how cooperatives can help achieve public policy objectives.
3. **OUTREACH.** The Center is prepared to inform the public on cooperatives and their significance to the economy of California.

While the University of California is responsible for its administration, the Center is intended to serve statewide. Its teaching and research resources are drawn from interested professionals from all UC campuses, the State University System, other colleges and universities, and sources indigenous to the cooperative business community.

The Center is prepared to receive gifts and contributions from the public, foundations, cooperatives and other like sources.

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