
PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted an audit to address various issues and concerns related to the closure and eventual dissolution of the Creamery Corporation which does business as Matanuska Maid (MatMaid). The Creamery Corporation was a private sector, dairy product wholesaler. The State of Alaska through the Department of Natural Resources, Division of Agriculture (DoAg), Agricultural Revolving Loan Fund (ARLF) is the sole stockholder in the Creamery Corporation.

REPORT CONCLUSIONS

As part of a multi-stage audit, we were directed to identify the sources of funding for the Division of Agriculture (DoAg) and Matanuska Maid (MatMaid). We were also directed to report on funding sources used to finance activities of the Board of Agriculture and Conservation (BAC) and the Creamery Board (Board). This funding information is set out in the organization and function and the background information sections of this report.

The Report Conclusions section sets out our findings related to the other audit objectives, as follows:

1. The Creamery Corporation has appropriately paid federal and state income tax.

2. All disbursements linked to state funding were consistent with appropriation language. Although the $600,000 General Fund appropriation was approved in June 2007, MatMaid did not receive the funds until November 2007. The funds were deposited in the corporation’s main checking account, commingled with the other corporate cash and operating proceeds. Since the state funds were commingled with MatMaid’s corporate cash, we analyzed all MatMaid expenditures between November 15, 2007 (the day after the state funds were received) and February 29, 2008.
We confirmed the expenditures identified as being funded by the state appropriation was consistent with the language accompanying the appropriation and reiterated by the Department of Natural Resources (DNR) financial managers.

3. Payment to dairy farmers inconsistent with the Creamery Board’s corporate responsibilities. Disbursements of just over $39,000 were made to four in-state dairy producers who had sold raw milk to MatMaid while it was an operating dairy. MatMaid’s governing board – the Creamery Board, decided to make a final payment to these suppliers after the end of operations, although they were under no contractual obligation. Such action is not consistent with the financial interest of the corporate shareholder – the State’s Agricultural Revolving Loan Fund. The funds were not attributed to the General Fund appropriation, but were made from other MatMaid funds.

4. MatMaid financial records indicate sufficient assets to cover known liabilities and creditors. The cash position of the corporation at the end of February 2008, and the underlying value of MatMaid equipment and rolling stock, indicates sufficient assets to pay known existing liabilities and creditors. Property located in Anchorage (on Northern Lights Boulevard) and in downtown Palmer on which MatMaid operated is owned by ARLF. The proceeds from any sale of these properties would not be used to fund future or unknown, MatMaid creditor claims.

5. State executive who oversaw MatMaid’s closure was compensated by the State, not the corporation. Since late August 2007, day-to-day management of MatMaid and wind-up has been carried out by a state official – a special assistant to the commissioner of Department of Commerce, Community, and Economic Development (DCCED). From our review of MatMaid expenditures, we saw no evidence this individual was compensated through the corporation. Rather, any compensation he received came through his capacity as a state employee.

We estimate the total state personnel costs for this individual was more than $45,000 between September 2007 and February 2008. In our view a conservative estimate would be that MatMaid was subsidized by at least $25,000 for the efforts of the state executive.

6. MatMaid equipment and rolling stock is accounted for and still sufficiently controlled.

7. Restrictions over loans for board members with ARLF have been observed.

PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted an audit to address various issues and concerns related to the closure and eventual dissolution of the Creamery Corporation which does business as Matanuska Maid (MatMaid). The Creamery Corporation was a private sector, dairy product wholesaler. The State of Alaska through the Department of Natural Resources, Division of Agriculture (DoAg), Agricultural Revolving Loan Fund (ARLF) is the sole stockholder in the Creamery Corporation.

REPORT CONCLUSIONS

As part of a multi-stage audit, we were directed to identify the sources of funding for the Division of Agriculture (DoAg) and Matanuska Maid (MatMaid). We were also directed to report on funding sources used to finance activities of the Board of Agriculture and Conservation (BAC) and the Creamery Board (Board). This funding information is set out in the organization and function and the background information sections of this report.

The Report Conclusions section sets out our findings related to the other audit objectives, as follows:

1. The Creamery Corporation has appropriately paid federal and state income tax.

2. All disbursements linked to state funding were consistent with appropriation language. Although the $600,000 General Fund appropriation was approved in June 2007, MatMaid did not receive the funds until November 2007. The funds were deposited in the corporation’s main checking account, commingled with the other corporate cash and operating proceeds. Since the state funds were commingled with MatMaid’s corporate cash, we analyzed all MatMaid expenditures between November 15, 2007 (the day after the state funds were received) and February 29, 2008.
We confirmed the expenditures identified as being funded by the state appropriation was consistent with the language accompanying the appropriation and reiterated by the Department of Natural Resources (DNR) financial managers.

3. Payment to dairy farmers inconsistent with the Creamery Board’s corporate responsibilities. Disbursements of just over $39,000 were made to four in-state dairy producers who had sold raw milk to MatMaid while it was an operating dairy. MatMaid’s governing board – the Creamery Board, decided to make a final payment to these suppliers after the end of operations, although they were under no contractual obligation. Such action is not consistent with the financial interest of the corporate shareholder – the State’s Agricultural Revolving Loan Fund. The funds were not attributed to the General Fund appropriation, but were made from other MatMaid funds.

4. MatMaid financial records indicate sufficient assets to cover known liabilities and creditors. The cash position of the corporation at the end of February 2008, and the underlying value of MatMaid equipment and rolling stock, indicates sufficient assets to pay known existing liabilities and creditors. Property located in Anchorage (on Northern Lights Boulevard) and in downtown Palmer on which MatMaid operated is owned by ARLF. The proceeds from any sale of these properties would not be used to fund future or unknown, MatMaid creditor claims.

5. State executive who oversaw MatMaid’s closure was compensated by the State, not the corporation. Since late August 2007, day-to-day management of MatMaid and wind-up has been carried out by a state official – a special assistant to the commissioner of Department of Commerce, Community, and Economic Development (DCCED). From our review of MatMaid expenditures, we saw no evidence this individual was compensated through the corporation. Rather, any compensation he received came through his capacity as a state employee.

We estimate the total state personnel costs for this individual was more than $45,000 between September 2007 and February 2008. In our view a conservative estimate would be that MatMaid was subsidized by at least $25,000 for the efforts of the state executive.

6. MatMaid equipment and rolling stock is accounted for and still sufficiently controlled.

7. Restrictions over loans for board members with ARLF have been observed.
Members of the Legislative Budget and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF NATURAL RESOURCES
DIVISION OF AGRICULTURE
AGRICULTURAL REVOLVING LOAN FUND
MATANUSKA MAID
Part 1

March 7, 2008

Audit Control Number
10-30049A-08

We conducted an audit of activities related to the closure and dissolution of Matanuska Maid (MatMaid) — a private sector corporation classified as an investment asset of the State of Alaska’s Agricultural Revolving Loan Fund (ARLF). The State, under the auspices of ARLF, is the sole shareholder in MatMaid.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the findings and discussion presented in this report are discussed in the Objectives, Scope, and Methodology.

Pat Davidson, CPA
Legislative Auditor
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objectives, Scope, and Methodology</td>
<td>1</td>
</tr>
<tr>
<td>Organization and Function</td>
<td>5</td>
</tr>
<tr>
<td>Background Information</td>
<td>9</td>
</tr>
<tr>
<td>Report Conclusions</td>
<td>19</td>
</tr>
<tr>
<td>Agency Responses</td>
<td></td>
</tr>
<tr>
<td>Department of Commerce, Community, and Economic Development</td>
<td>29</td>
</tr>
<tr>
<td>Department of Natural Resources</td>
<td>31</td>
</tr>
<tr>
<td>The Creamery Corporation</td>
<td>35</td>
</tr>
<tr>
<td>Legislative Audit’s Additional Comments</td>
<td>45</td>
</tr>
</tbody>
</table>
OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted an audit to address various issues and concerns related to the closure and eventual dissolution of the Creamery Corporation which does business as Matanuska Maid (MatMaid). The Creamery Corporation was a private sector, dairy product wholesaler. The State of Alaska, through the Department of Natural Resources, Division of Agriculture (DoAg), Agricultural Revolving Loan Fund (ARLF), is the sole stockholder in the Creamery Corporation.

Objectives

This report is the first of a multi-part audit, with the following objectives:

1. Identifying the sources of funding for FY 05 through FY 07 for the activities of DoAg, MatMaid, the Board of Agriculture and Conservation (BAC), and the Creamery Board.

2. Analyzing and discussing the financial relationships between ARLF, MatMaid, BAC, and the Creamery Board.

3. Determining whether MatMaid is required to pay federal and state taxes on income earned.

4. Identifying the disbursements made from a $600,000 state general fund appropriation and determining if the disbursements are consistent with purpose of the appropriation.

5. Preparing a balance sheet for the Creamery Corporation as of the beginning of 2008 and identifying the sources and uses of cash received after that time.

6. Identifying the source of compensation paid to the state executive who served as the on-site MatMaid manager beginning in August 2007.

7. Determining if MatMaid assets are being adequately controlled.

8. Identifying individuals who have sat on BAC or the preceding ARLF oversight board to determine if actions related to their loans from the fund were consistent with restrictions set out in state law.
Scope and Methodology

In order to meet the various objectives of the audit, our fieldwork included:

- Review of statutes related to the ARLF program to determine the responsibilities of the BAC as the fund’s administrator and the restrictions applicable to board members with ARLF loans.

- Review of MatMaid’s historical bankruptcy documents. These documents detail the assets owned at the time of bankruptcy. This review provided a better understanding of the financial relationships that resulted from the bankruptcy.

- Interviews with personnel from the Department of Natural Resources, Divisions of Support Services and Agriculture; Department of Law; Department of Commerce, Community, and Economic Development; and MatMaid. The interviews provided additional perspective on the funding sources and financial relationships between DoAg, ARLF, MatMaid, BAC, and the Creamery Board. Interviews also provided further understanding of the federal and state tax laws that require MatMaid to pay taxes on income earned. The interviews served as the basis for our assessment of the nature and extent of work performed by state executives and employees involved with the closure and dissolution of MatMaid.

- Review of FY 05 through FY 07 financial information from the state accounting system and state budget documents in order to identify the source of funds used to finance DoAg, ARLF, and BAC activities.

- Review of historical ARLF loan records to identify the amount MatMaid owed the State at the time of bankruptcy, to determine payments made to protect the collateral, and identify any subsequent cash contributions to MatMaid.

- Analysis of MatMaid accounting records related to the corporation’s operating years (which correspond to calendar year) 2005, 2006, and 2007. Additionally, we reviewed documentation related to expenditures and revenues made or received in January and February 2008. Our analysis allowed us to identify the sources of the corporation’s revenues. Review of the financial records also provided the source of funds used to finance the Creamery Boards activities.

- Analysis of MatMaid cash disbursements and deposits since the company received the $600,000 legislative appropriation. Our analysis included reviews of the 2007 and 2008 bank statements, cash disbursement logs, deposit slips, and copies of checks. We used this information to analyze cash disbursements for consistency with the language and general interpretation of the legislative appropriation. We also used this information to estimate the cash balance of MatMaid at the end of February 2008.
• Review of personnel and payroll records from the state accounting system since August 2007 to identify state employee labor costs attributable to the closure of MatMaid.

• Analysis of MatMaid’s balance sheet, accounts payable, and accounts receivable financial records related to 2007 and 2008 operations to determine the ability of MatMaid to pay creditors.

• Verification of an extensive sample of MatMaid personal property and equipment (PPE). This was done using an October 2007 inventory and valuation appraisal of MatMaid’s PPE. This was done to ensure MatMaid’s equipment and rolling stock could be accounted for and was being appropriately controlled.

• Review of BAC and Creamery Board minutes, state press releases, board resolutions, memorandums, and correspondence. These documents provided an understanding of the background of the $600,000 legislative appropriation and basis for many of the decisions made by the Creamery Board.

• Analysis of historical ARLF loan records to identify board members with agriculture loans. For individuals who had loans while serving on the ARLF loan oversight committee or the BAC, we reviewed the individual loan file. This was done to confirm no action was taken on the loan during the term served that was inconsistent with restrictions imposed by state law.
(Intentionally left blank)
ORGANIZATION AND FUNCTION

The goal of the Department of Natural Resources (DNR) is to contribute to Alaska's economic health and quality of life by protecting and maintaining the state's resources, encouraging wise development of these resources, and making them available for public use. DNR manages all state-owned land, water and natural resources, except for fish and game, on behalf of the people of Alaska.

DNR is currently organized into eight divisions that reflect its major programs: (1) Agriculture; (2) Coastal and Ocean Management; (3) Forestry; (4) Geological and Geophysical Surveys; (5) Mining, Land, and Water; (6) Oil and Gas; (7) Parks and Outdoor Recreation; and, (8) Support Services.

Division of Agriculture (DoAg)

The Division of Agriculture: (1) offers land for agricultural development; (2) works with local producers to promote and support the state’s agricultural industry through provision of financing for farmers and processors; (3) promotes plant material research and development; (4) promotes conservation education; (5) provides marketing assistance, inspection, and farm product certification. There are 32 permanent full-time and 12 permanent, part-time budgeted positions.¹

DoAg’s main office is located in Palmer. The Plant Materials Center is an industrial/laboratory complex consisting of several buildings located on a tract in the rural Mat-Su Valley near Pioneer Peak. DoAg also has a northern region satellite office located in Fairbanks.

The functions of DoAg are divided between three organizational components as follows:

Agriculture Development component

- **Sales and leases of state land with agricultural covenants.** Under this component the division carries out its responsibilities for selling and administering Title 38 (Public Land) property with agricultural covenants.

- **Institutional advertising.** The division administers the Alaska Grown program and provides assistance to producers to promote the sale of their products.

- **Inspections.** The division provides inspections and grading of agriculture products. It also provides field inspections for seed certification and disease control.

¹ Of the 44 budgeted positions, 37 were filled during FY 07.
Agricultural Loan Fund Administration

- Farm loans. The division currently processes and services Agricultural Revolving Loan Fund (ARLF) loans, which are approved by the Board of Agriculture and Conservation. The servicing of ARLF loans includes collections and the sales of repossessed property and collateral.

- Oversight of farm-related industrial facilities. The division owns farm-related industrial facilities. Some of these are operated by the division while others are made available to the private sector under various arrangements.

Plant Materials Center

- Applied research. The Plant Materials Center (PMC) provides for the production and development of plant materials. PMC is basically the state repository for Alaska seed and is responsible for encouraging the development of the seed industry.

Additionally, there are two boards that assist in carrying out the functions of DoAg.

- Alaska Natural Resource Conservation and Development Board. This board primarily acts in an advisory capacity to DNR’s commissioner for soil and water conservation issues and concerns.

- Board of Agriculture and Conservation (BAC). State law (at AS 03.09 and AS 03.10) establishes the BAC and sets out the powers of the board. This citizen board has seven members appointed by the governor who serve staggered, three-year terms. The board is responsible for loan approvals, development of recommendations related to state agriculture policy, and overall oversight of state-owned agriculture facilities. See Exhibit 1 for the list of current board members.

Exhibit 2, on the following page, summarizes the funding sources for DoAg. As discussed, the division is comprised of three budget components: Agriculture Development, Agricultural Loan Fund Administration, and the Plant Materials Center. Funding for these sections come from the state’s general fund, federal funding, ARLF, the Land Disposal Income Fund, and inter-agency receipts. The total funding for the division for the past three
years has been over $4 million. Funding for BAC operations is a small part of ALRF’s administration funding.

As indicated in Exhibit 2, in recent years ARLF has provided funding for the agriculture development and plant materials function within the Division of Agriculture. For the current operating year (FY 08), no ARLF funds are being used to support either the agriculture development or plant materials center budget components.³

<table>
<thead>
<tr>
<th>Division of Agriculture</th>
<th>Source of Funding²</th>
<th>FY 2005 – FY 2007 (rounded)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Agriculture Development:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agricultural Revolving Loan Fund</td>
<td>$67,600</td>
<td>$139,700</td>
</tr>
<tr>
<td>Federal Receipts</td>
<td>294,300</td>
<td>346,500</td>
</tr>
<tr>
<td>Land Disposal Income Fund</td>
<td>338,800</td>
<td>366,100</td>
</tr>
<tr>
<td>General Fund</td>
<td>619,000</td>
<td>739,900</td>
</tr>
<tr>
<td><strong>Total Agriculture Development</strong></td>
<td>$1,319,700</td>
<td>$1,592,200</td>
</tr>
<tr>
<td><strong>Agricultural Loan Fund Admin:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agricultural Revolving Loan Fund</td>
<td>$1,787,600</td>
<td>$1,879,900</td>
</tr>
<tr>
<td><strong>Total Agricultural Loan Fund Admin</strong></td>
<td>$1,787,600</td>
<td>$1,879,900</td>
</tr>
<tr>
<td><strong>Plant Materials Center</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agricultural Revolving Loan Fund</td>
<td>$522,500</td>
<td>$622,600</td>
</tr>
<tr>
<td>Federal Receipts</td>
<td>634,300</td>
<td>588,200</td>
</tr>
<tr>
<td>Inter-Agency Receipts</td>
<td>4,500</td>
<td>140,700</td>
</tr>
<tr>
<td>General Fund</td>
<td>39,600</td>
<td>31,000</td>
</tr>
<tr>
<td><strong>Total Plant Materials Center</strong></td>
<td>$1,200,900</td>
<td>$1,382,500</td>
</tr>
<tr>
<td><strong>Division of Agriculture Total</strong></td>
<td>$4,308,200</td>
<td>$4,854,600</td>
</tr>
</tbody>
</table>

Source: State of Alaska Accounting System

As indicated in Exhibit 2, in recent years ARLF has provided funding for the agriculture development and plant materials function within the Division of Agriculture. For the current operating year (FY 08), no ARLF funds are being used to support either the agriculture development or plant materials center budget components.³

² These represent actual use of funds during the identified fiscal year, regardless of the appropriation year.
³ The FY 07 Governor’s Operating Budget for Department of Natural Resources, Agricultural Revolving Loan Program Administration, included the following statements which seemingly contributed to a switch in funding sources in the FY 08 budget:

**ARLF provides an operating subsidy for program-wide Division of Agriculture expenditures. This results in an ongoing erosion of ARLF funds and jeopardizes the solvency of the fund. Management is making efforts to minimize the draw on the fund.**

**If we do nothing and continue to operate as we do currently, ARLF will be depleted in approximately two years. Our goal is sustainability.**
Agricultural Revolving Loan Fund (ARLF)

ARLF was established by the territorial legislature in 1953. The fund’s enabling legislation is codified in state law at AS 03.10. ARLF’s enabling legislation authorizes the following six types of loans: short-term operating; chattel; farm development; irrigation systems; land clearing; and, product processing. By regulation, DNR has established a five percent interest rate for all loan types. A borrower’s total outstanding ARLF balance may not exceed $1 million. Only Alaska residents are eligible for loans. As reflected in the FY 07 balance sheet in Exhibit 3, the fund has more than $8.5 million in loans outstanding and cash of more than $4 million at last fiscal year-end.

Exhibit 3
Agricultural Revolving Loan Fund
Balance Sheet
June 30, 2007

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets:</td>
<td></td>
</tr>
<tr>
<td>Cash and Investments</td>
<td>$4,292,000</td>
</tr>
<tr>
<td>Accounts Receivable – Net</td>
<td>89,000</td>
</tr>
<tr>
<td>Interest and Dividends Receivable</td>
<td>125,000</td>
</tr>
<tr>
<td>Loans, Notes, and Bonds Receivable</td>
<td>1,202,000</td>
</tr>
<tr>
<td>Total Current Assets</td>
<td>5,708,000</td>
</tr>
<tr>
<td>Noncurrent Assets:</td>
<td></td>
</tr>
<tr>
<td>Loans, Notes, and Bonds Receivable</td>
<td>8,525,000</td>
</tr>
<tr>
<td>Repossessed Property</td>
<td>871,000</td>
</tr>
<tr>
<td>Investment in Projects, Partnerships, or Corporations</td>
<td>6,841,000</td>
</tr>
<tr>
<td>Other Noncurrent Assets</td>
<td>1,445,000</td>
</tr>
<tr>
<td>Total Noncurrent Assets</td>
<td>17,682,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$23,390,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities:</td>
<td></td>
</tr>
<tr>
<td>Accounts Payable and Accrued Liabilities</td>
<td>$66,000</td>
</tr>
<tr>
<td>Due to Other Funds</td>
<td>75,000</td>
</tr>
<tr>
<td>Claims, Judgments, and Compensated Absences</td>
<td>84,000</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td>225,000</td>
</tr>
<tr>
<td>Noncurrent Liabilities</td>
<td>66,000</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>$291,000</td>
</tr>
</tbody>
</table>

Fund Equity                     | $23,099,000 |

Total Liabilities and Fund Equity | $23,390,000 |


---

4 This account is made up of a $2.8 million valuation assigned to the Alaska Farmer’s Cooperative and the balance of the account of just over $4 million is the assigned book value for Matanuska Maid.
BACKGROUND INFORMATION

The Matanuska Maid (MatMaid) corporation traces its origins back to 1935. A federal “New Deal” program, known as the Alaska Rural Rehabilitation Corporation moved approximately 200 families from the economically depressed Midwest to southcentral Alaska. These families accepted the federal government’s offer of a 40-acre homestead to clear and farm. The federal agency also provided some basic equipment, free seed, and a long-term low interest loan. These families proceeded to build what came to be known as “the colony.”

In 1936, the Matanuska Valley Farmer’s Cooperative Association was formed. The cooperative opened a creamery plant, processing most of the dairy farmers’ milk into butter. By 1940, there was enough surplus milk to begin bottling and selling to local businesses. Twenty-two years later, the cooperative adopted Matanuska Maid as the company name.

MatMaid expanded beyond selling just milk

In the beginning MatMaid’s primary business was the production, bottling, and selling of milk to local stores. Eventually, the company became profitable enough to finance expansion of its product line. MatMaid began to sell products such as ice cream, yogurt, and sour cream. Additionally, it began to sell milk in a wider variety of sizes.

During the early 1990s, MatMaid further expanded its operations to include plastics manufacturing. The company began making plastic jugs for its milk and other products while also selling the jugs and plastic bottles to other businesses. After expanding operations into the plastics manufacturing, MatMaid entered the bottled water market in the late 1990s.

Although MatMaid expanded its operations, the processing and sale of milk continued to be its main focus. Almost three-fourths of MatMaid revenues came from the sale of milk. Almost half of the operating expenses were associated with the shipment and delivery of milk.

Exhibit 4, on the following page, provides and summarizes the source of sales and other revenues for the last three years of MatMaid operations. Since the Creamery Board manages the business and affairs of MatMaid, funding provided to finance any board-related activities is provided by MatMaid. The Creamery Board is not financially part of DoAg or included in DoAg’s budget.

MatMaid went bankrupt in 1983 and the State, as the largest creditor, took over operations

Between 1979 and 1982, MatMaid borrowed money from the Agricultural Revolving Loan Fund (ARLF), utilizing Anchorage real estate as collateral. Due to a considerable amount of
debt owed to ARLF, approximately $3 million, MatMaid management decided to declare Chapter 11 bankruptcy protection in 1983.\(^5\)

### Exhibit 4

<table>
<thead>
<tr>
<th>Matanuska Maid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues and Expenses</td>
</tr>
<tr>
<td>For Years 2005, 2006, 2007 (rounded)</td>
</tr>
<tr>
<td>Operating:</td>
</tr>
<tr>
<td>Revenue Sources:</td>
</tr>
<tr>
<td>Milk</td>
</tr>
<tr>
<td>Other dairy products</td>
</tr>
<tr>
<td>Bottled water</td>
</tr>
<tr>
<td>Other plastic containers</td>
</tr>
<tr>
<td><strong>Total Revenue:</strong></td>
</tr>
<tr>
<td>Expenses:</td>
</tr>
<tr>
<td>Revenues Compared to Expenses:</td>
</tr>
<tr>
<td>Other Revenue/Expense, Net:</td>
</tr>
<tr>
<td><strong>Net Revenues Compared to Expenses:</strong></td>
</tr>
</tbody>
</table>

*Source: Prepared from Matanuska Maid accounting records. 2006 and 2007 amounts are unaudited.*

The State, through its role as ARLF’s administrator, was MatMaid’s largest creditor at the time of bankruptcy. In 1984, the bankruptcy court permitted ARLF to take possession and operate MatMaid. The State made this decision primarily to provide a market for the milk produced on ARLF-financed dairies and to preserve the value of the repossessed assets.\(^6\) A year later, the State acquired legal title to the Anchorage and Palmer\(^7\) real property. In 1988, the bankruptcy court issued its final order to transfer all remaining MatMaid assets to ARLF.

---

\(^5\) A filing under chapter 11 of the U.S. Bankruptcy Code is frequently referred to as a “reorganization” bankruptcy. Chapter 11 is typically used to reorganize a business, which may be a corporation, sole proprietorship, or partnership. A corporation exists separate and apart from its owners, the stockholders. A chapter 11 bankruptcy of a corporation (corporation as debtor) does not put the personal assets of the stockholders at risk other than the value of their investment in the company's stock.

\(^6\) An audit report by the Governor’s Office, Office of Management and Budget, *Review of the Creamery Corporation d/b/a Matanuska Maid Dairy*, Audit No. 10-46 (August 1990), indicates that there were two purposes for the State’s acquisition of Matanuska Maid: “protect the collateral and recover the loans made by the ARLF” and “provide a market to the Point MacKenzie and Palmer area dairy farmers.”

\(^7\) At the time of the bankruptcy, the Palmer real property was used as a feed manufacturing, storage, and sales facility.
All personal property acquired after 1988, including accounts receivable, equipment, inventory, MatMaid logos, trademarks, and other intangibles is owned by MatMaid. In exchange for possession of the Anchorage and Palmer property (which is owned by ARLF), for purposes of operating the business, MatMaid pays all real property taxes, assessments, insurance, and utilities.

In 1988, the State incorporated MatMaid as the Creamery Corporation. This action was to provide corporate structure to operate the dairy, with the goal of MatMaid eventually becoming independent from the State. At the inception of the Creamery Corporation, a share certificate representing one thousand shares was issued to ARLF. The Creamery Corporation had its own executive board – the Creamery Board – which is responsible for the oversight of MatMaid operations.

According to MatMaid management, after the bankruptcy court permitted ARLF to take possession and operate MatMaid in 1984, additional funds were invested to upgrade the MatMaid facility, its plant equipment, and truck fleet. Some of the funds were also used for daily operations and to secure trade credit. Between 1986 and 1990, ARLF provided approximately $2 million in additional investment in MatMaid.

Legislature establishes a board to oversee ARLF and act as state shareholder for MatMaid

Prior to 2000, the State, as the sole shareholder of the Creamery Corporation, was represented by the commissioner of Department of Natural Resources (DNR) in the corporate affairs of the company. In 2000, state law was changed and the administration of ARLF and its investments shifted from the commissioner of DNR to the newly formed Board of Agriculture and Conservation (BAC). This new board, representing the State as the sole shareholder, appoints the Creamery Board. BAC, in turn, is appointed by the governor. Exhibit 5, on the next page, illustrates the organizational relationships between the governor, BAC, the Creamery Board, and MatMaid.

As of June 2007, more than 40 employees were working at MatMaid. All the employees, including management, were employed directly by the company and were not compensated by the State’s personnel or retirement system. MatMaid provided for the salary and benefits from its own operating revenues.

---

8 The original MatMaid logo was transferred to the State by MatMaid in 1988. The State assigned to MatMaid its rights, title, and interest in the logo in 1995.
In 2005 operating losses at MatMaid began to accumulate

Prior to 2005, MatMaid had operating income sufficient to fund its operations.¹⁹ According to a former chair of the Creamery Board, a variety of economic factors¹⁰ adversely affected MatMaid, leading to a loss in profitability. Operating losses for 2005 amounted to $282,000.¹¹ Although there are no 2006 audited financial statements for MatMaid, management reported estimated operating losses between $450,000 and $550,000¹² for the year. The company continued to report losses in 2007. In response to operating losses, the Creamery Board began the process of closing operations in the late part of 2007.

---

³ For the 2004 operations, MatMaid reported operating income of over $110,000.
⁴ The former chairman of the Creamery Corporation listed the following factors as contributing to reduction in the profitability of MatMaid:
  - Changes to federal food programs, such as school lunch program, that mandated participants to select only the lowest-cost milk product.
  - The U.S. Department of Defense stopped purchasing local Alaska milk.
  - Federal homeland security policy decisions over the importing of milk from the Lower 48 states.
  - Grocery stores’ decision to raise the price of MatMaid milk products compared to their store brand.
  - Loss of all but seven producing dairy farms in Alaska.
  - Ban on shipment of cows across the U.S.-Canada border.
  - Higher costs for shipping, utilities, insurance, and supplies for raw milk.

¹¹ As reported in the audited financial statements for the Creamery Corporation, dba Matanuska Maid Dairy for years ended December 31, 2005 and 2004.
¹² As reported in the unaudited monthly income statements for MatMaid as loss from operations.
Legislature appropriated $600,000 to facilitate MatMaid’s operational shutdown

As operating losses increased, it became apparent to the Creamery Board that MatMaid would need to seek financial assistance from the legislature. In early 2007, the Creamery Board asked BAC to request $600,000 in funding from the legislature to offset operating losses. BAC agreed, and presented a resolution to the legislature, which stated,

... the Board of Agriculture and Conservation requests that the Alaska State Legislature approve an appropriation in the amount of $600,000 which would provide for continued operations of the Matanuska Maid Dairy as it plans ways to meet Alaska’s challenging market conditions; to provide for an independent review of its operating income and expenses every 30 days; to obtain independent expert advice to develop a plan to maximize its asset value; and implement cost-cutting measures.

Subsequently, MatMaid’s manager and the Creamery Board became increasingly concerned about specific conditions, restrictions, limitations, reporting procedures, or any other requirements that might be attached to a prospective appropriation. In response, DNR stated it was the department’s intent “to utilize the funds consistent with a plan that will achieve a specific result.”

Accordingly, DNR requested that a formal plan and strategy be developed for the use of the funds. Further, the department stated no expenditures would be approved without assurance the spending would accomplished a specific objective of the plan. At its June 6, 2007 meeting, because of DNR’s proposed conditions, the old Creamery Board voted unanimously to reject receipt of the pending appropriation.

At the end of June 2007, legislation appropriating $600,000 from the general fund was signed by the governor. In November 2007, the new Creamery Board formally requested the release of the $600,000 appropriation. The request stated:

... the funds will be used for ongoing business obligations of the Dairy and for employee severance packages related to the upcoming closure in December, 2007. It is understood that the Creamery Corporation will return these funds, or parts thereof, to the State of Alaska if proceeds from the anticipated sale of corporate assets are sufficient and all our obligations have been satisfied.

DNR released the full $600,000 in funding at the beginning of November to MatMaid. The funds were deposited in MatMaid’s main checking account – commingling the appropriation with corporate operating funds.

---

13 DNR management stated any plan for the funding must identify: (1) how and what measures are being taken to reduce costs; (2) how and where the appropriation fits into a plan with a clear objective; and, (3) how far the appropriation will take MatMaid in achieving specific objectives.
14 Chapter 30, SLA 2007, Section 18(b) provided that the “...sum of $600,000 is appropriated from the general fund to the Department of Natural Resources for assistance to the Creamery Corporation, dba Matanuska Maid.”
Governor Palin removes old governing board, appoints all new members to BAC

After more than two consecutive years of operating losses, the Creamery Board voted in June 2007 to wind up MatMaid operations. After the Board announced its intent to close down MatMaid, Governor Palin intervened. She removed all of the incumbent BAC members and appointed seven other individuals. After the first meeting of the new BAC, the annual shareholder meeting for MatMaid was held and two actions were taken: (1) all the directors of the Creamery Board were removed; and, (2) all of the recently appointed BAC members were elected to the BAC.
board members appointed themselves to serve as temporary or interim members of the Creamery Board.

The new Creamery Board met after the shareholder meeting and initiated a motion to reverse the plan to close MatMaid which had been approved by the prior Board. However, this motion was never voted on; rather a new, more nuanced, motion was adopted to:

... continue regular operations at Matanuska Maid for a period of time, funded with the addition of the $600,000 allotted by the state, for the purpose of determining if there can be another plan developed, and the time period for the development of any plan to occur within 90 days.

Also at this meeting, the new Board announced that the governor had established a task force to work with the Creamery Board. The task force would help determine future options for the corporation. Days later, another Creamery Board meeting was held, where seven task force members were named.

State executive was assigned to oversee day-to-day operations during shutdown

One task force member, special assistant to the commissioner of Department of Commerce, Community, and Economic Development (DCCED), was named the liaison with the Creamery Board. The special assistant was also designated as the contact for any inquiries for information between the task force, the Creamery Board, and MatMaid staff. DCCED funded all the expenses of administering the task force activities.

During the transition between various boards of directors, and the assignment of the task force, the MatMaid’s chief executive officer (CEO) continued to work under an extended contract. The CEO agreed to work for the new Creamery Board through the end of August 2007. As the end of August approached, it became evident to the new Creamery Board that they would need an interim CEO to oversee MatMaid beyond the end of the month.

The uncertain future of MatMaid made it difficult to recruit a qualified, long-term replacement for the outgoing CEO. It was determined that the best solution was to delegate day-to-day management of MatMaid to the DCCED commissioner’s special assistant, since he recently had become very familiar with MatMaid in his role as a task force member. This decision was agreed upon by commissioners of both DNR and DCCED.

As task force recommends, Creamery Board seeks to sell MatMaid intact to another operator

In August 2007, the task force presented their recommendations to the Creamery Board. In its report the task force concluded that the “current business model has finally failed” and the State should “exit the creamery business and promote private enterprise” to take over MatMaid. In September 2007, the new Creamery Board recommended closure of MatMaid, the transition of the company to the private sector, an audit of the financial records, and the
hiring of a specialized broker to assist with the disposal of assets. In addition, in accordance with state law, the Creamery Board sought shareholder approval to sell all, or substantially all, of its assets.

BAC approved this request and set the minimum bid for all personal and real property at just over $3 million. BAC believed it was in the best interest of the State to offer for sale the entire MatMaid operation, including real property, in order to attract bidders who could continue processing milk in Alaska. Offering the entire MatMaid operation for sale also allowed individuals who may have been only interested in parts of the operation to join efforts and submit a bid for the entire operation. Before publishing the notice soliciting bids, BAC held a public hearing and made written findings in formal decisional document.

In November 2007, the Creamery Board voted to cease operations in mid-December. At this point, as operations were coming to a close, a new smaller scaled dairy was starting up. The new dairy, the Southcentral Dairy Joint Venture (SDJV), was initially funded in large part through a grant from the U.S. Department of Agriculture. SDJV requested the Creamery Board authorize the leasing of 12 pieces of industrial dairy manufacturing equipment to their company. After ascertaining the equipment would not interfere with its efforts to sell MatMaid intact, the Creamery Board approved the request. After no bids were received in early December for MatMaid operations as a whole, additional pieces of equipment were leased to SDJV.

Restrictions over Agricultural Revolving Loan Fund (ARLF) loans held by board members

The ARLF board was established by the territorial legislature to manage the fund when it was originally established in 1953. Under the original law, the board consisted of five members appointed by the governor and confirmed by the legislature. Subsequently, the board was increased to seven and the amended law prohibited any members serving who were delinquent on any ARLF loan payments. Board members served at the pleasure of the governor for overlapping three-year terms. Besides the delinquency prohibition, board members were restricted under statute from obtaining a loan during their term or within a year after their term ended.

BAC was created by the legislature in 2000 to replace the old ARLF oversight board. Among other responsibilities, BAC took over responsibility to administer ARLF loans.

---

15 AS 10.06.570(a)
16 Three of the five members were to be farmers, one member was to be a banker, and one member was to be selected from the public at large.
17 Under the previous law related to the membership on the ARLF oversight board, the designated farmer-members had to either be currently operating, or had past experience operating, a producing farm in the State for at least five years.
18 Restrictions on board members’ loan eligibility did not apply to those that were classified as “short term” loans.
Like its predecessor board, BAC was made up of seven members appointed by the governor and confirmed by the legislature.19

State law requires that while serving on BAC, a board member, or an immediate family member may not obtain, modify, or restructure an agriculture loan. The previous prohibition against obtaining an ARLF loan one year after the end of a term, which had applied to the prior board, was lifted for BAC.

Although currently the composition of BAC and the Creamery Board is the same, this was not always the case. In the past, individuals serving only on the Creamery Board were not restricted from obtaining or modifying any loan from ARLF while serving on the Creamery Board.

19 State law, at AS 03.10.050, provides that BAC members have the following qualifications:
   1. one member shall have general business or financial expertise;
   2. one member shall be a member of a statewide agricultural promotion organization;
   3. one member shall be a member of the soil and water conservation district;
   4. four members shall be engaged in commercial production agriculture; each shall represent a different agriculture enterprise from the others, such as livestock production, dairy, vegetable production, grain production, horticulture production, and greenhouse or hydroponics production.
(Intentionally left blank)
REPORT CONCLUSIONS

As part of a multi-stage audit, we were directed to identify the sources of funding for the Division of Agriculture (DoAg) and Matanuska Maid (MatMaid). We were also directed to report on funding sources used to finance activities of the Board of Agriculture and Conservation (BAC) and the Creamery Board. This funding information is set out in the organization and function and the background information sections of this report.

This section addresses various issues and concerns related to the closure of MatMaid and the disposal of the corporation’s assets. The operation closure and asset disposal is an ongoing process, with some aspects yet to be completed. In this report, we address the following objectives:

1. Determination of whether MatMaid is required to pay federal and state taxes on income earned.

2. Identification of the disbursements made from a $600,000 general fund appropriation and determining if the disbursements were consistent with purpose of the appropriation.

3. Preparation of a balance sheet for the Creamery Corporation as of the beginning of 2008 and identification of the sources and uses of cash received after that time.

4. Identification of the total compensation paid to the state executive who served as the on-site MatMaid manager since September 2007. Identifying the source and reasonableness for the compensation.

5. Assessment as to the adequacy of control being maintained over MatMaid’s assets.

6. Identification of individuals who have sat on BAC or the preceding ARLF oversight board to determine if actions related to any loans they may have had from the fund were consistent with restrictions set out in state law.

From our review, we draw the following conclusions:

1. The Creamery Corporation has appropriately paid federal and state income tax.

2. State funding was commingled with operating funds, specific disbursements linked to appropriation were consistent with legislative and administrative language.

3. Payment to dairy farmers was inconsistent with Creamery Board’s corporate responsibilities.

4. MatMaid financial records indicate sufficient assets to pay known liabilities and creditors.
5. The state executive responsible for day-to-day oversight of MatMaid during its closure and dissolution was compensated by the State, receiving no payment through the corporation.

6. MatMaid equipment and rolling stock is accounted for and sufficiently controlled.

7. Creamery Board members complied with ARLF loan restrictions.

More extensive discussion of these conclusions follows:

**Creamery Corporation appropriately pays federal and state corporate income tax**

The Creamery Corporation pays federal and state taxes on income earned from MatMaid operations. At the time of incorporation, an opinion was requested from an auditing firm to determine if the newly formed corporation would be subject to federal income tax. It was determined that MatMaid would become subject to federal income taxes after incorporation, even if the State is the sole shareholder. This determination was confirmed more recently by the Department of Law’s assistant attorney general.

According to the investigative report received from the accounting firm, under Internal Revenue Service Code Section 115, gross income does not include: (1) income derived from any public utility or the exercise of any “essential governmental function” and (2) income “accruing” to the State.

MatMaid’s income is not derived from a public utility, nor do they perform an essential government function. Since MatMaid is a separate legal and taxable entity, any income it earned would not be considered to be earned by the State. Additionally, income earned does not accrue to the State. Based on these facts, MatMaid is not exempt under Section 115 and is required to pay federal income taxes. The State levies a corporate net income tax based on federal taxable income. Accordingly, MatMaid also pays state income taxes as earnings permit.

**All disbursements linked to state funding were consistent with appropriation language**

Although the $600,000 General Fund appropriation was approved in June 2007, MatMaid did not receive the funds until November 2007. The funds were deposited in the corporation’s main checking account, commingled with the other corporate cash and operating proceeds. Since the state funds were commingled with MatMaid’s corporate cash, we analyzed all MatMaid expenditures between November 15, 2007 (the day after the state funds were received) and February 29, 2008. See Exhibit 7 on the following page. In March 2008, we received a summary schedule of the cash disbursements from MatMaid. We confirmed the expenditures identified as being funded by the state appropriation was

---

20 Since 2005, MatMaid has reported losses and, therefore, does not pay income taxes, but is able to carry back and forward its losses.
consistent with the language accompanying the appropriation and reiterated by the Department of Natural Resources (DNR) financial managers.\textsuperscript{21}

\begin{center}
\begin{tabular}{|l|c|}
\hline
\textbf{Exhibit 7} & Matanuska Maid \tabularnewline
 & Cash Balance and Disbursement Activity \tabularnewline
 & January 1 through February 29, 2008 \tabularnewline
 & (rounded) \tabularnewline
\hline
Cash Balance, January 1, 2008 & \$ 696,600 \tabularnewline
\hline
\textbf{Cash Disbursements:} & \tabularnewline
\textit{Personnel:} & \tabularnewline
Payroll & \$ 260,800 \tabularnewline
Taxes & 131,000 \tabularnewline
Pension & 68,000 \tabularnewline
Insurance & 63,000 \tabularnewline
Other & 11,400 \tabularnewline
\hline
\textit{Supplies:} & \tabularnewline
Operating & 80,500 \tabularnewline
Quality Control & 12,900 \tabularnewline
Automobile Fuel & 4,700 \tabularnewline
Office & 5,400 \tabularnewline
Miscellaneous & 3,100 \tabularnewline
\hline
\textit{Transportation/Cartage:} & 547,900 \tabularnewline
\hline
\textit{Buildings:} & \tabularnewline
Utilities & 80,000 \tabularnewline
Maintenance & 30,000 \tabularnewline
Rent & 8,000 \tabularnewline
Taxes & 2,500 \tabularnewline
\hline
\textit{Fees:} & \tabularnewline
Audit Firms & 21,200 \tabularnewline
Legal Firms & 27,700 \tabularnewline
\hline
\textit{Milk Producers (suppliers):} & \tabularnewline
\text{ Formula Payments based on Past Raw Milk Production } & 39,300 \tabularnewline
\hline
\textbf{Total Disbursements:} & \$ 1,397,400 (\$ 1,397,400) \tabularnewline
\hline
\textbf{Cash Deposits (Primarily Payment on Accounts and Equipment Lease Revenues):} & \$ 866,800 \tabularnewline
\hline
\textbf{Estimated Cash Balance, February 29, 2008:} & \$ 166,000 \tabularnewline
\hline
\end{tabular}
\end{center}

\textit{Source: Mat-Maid Financial Records}

\textsuperscript{21}According to the letter from the Creamery Board to DNR, the funds would be used \textit{“for ongoing business obligations of the Dairy”} in addition to paying for employee severance.
Payment to dairy farmers inconsistent with Board’s corporate responsibilities

Disbursements of just over $39,000 were made to four in-state dairy producers who had previously sold raw milk to MatMaid. The Creamery Board first approved such payments at their January 15, 2008 meeting. The Creamery Board voted to make the payment from the state appropriation, but recognized that it was not clear if such action was consistent with the terms of the appropriation. After some discussion and review within executive branch officials, it was ultimately determined that such a use of the state appropriation was not consistent with the intent of the funding.

At a subsequent meeting on January 26th, the Creamery Board again approved the payments – this time specifying that corporate MatMaid funds were to be used rather than the appropriated funds. Given there was no contractual or legal obligations to make such payments, such disbursements are inconsistent with the customary duties and responsibilities of Creamery Board members.

Authoritative legal principles22 require:

The directors of a corporation are entrusted with the management of its business and the property for the benefit of all the shareholders, and occupy the position of trustees for the collective body or shareholders in respect to such business. They cannot use the trust property, or their relation to it, for their own personal gain. It is their duty to administer the corporate affairs for the common benefit of all the shareholders, and exercise their best care, skill and judgment in the management of the corporation business solely in the interest of the corporation.

Making payments to individuals who are neither creditors nor shareholders is not consistent with the financial interest of the corporate shareholder – the State’s Agricultural Revolving Loan Fund.

Other legal guidance23 recognizes additional duties of care for directors of financially distressed corporations. Specifically:

In general terms, officers and directors owe duties of care and fiduciary duties of loyalty to the corporation itself and not to its creditors. They are expected to act in good faith and with the honest belief that the actions they take are in the best interests of the corporation and are designed to maximize the wealth of the shareholders.

---

22 Fletcher Cyclopedia Corporations Vol. 3
23 The Law of Corporations, Robert W. Hamilton
Since MatMaid has ceased production and is winding up operations, state law at AS 10.06.665 limits distribution of assets to shareholders in accordance with the right to access. Specifically:

*After determining that all of the known debts and liabilities of a corporation in the process of winding up have been paid or adequately provided for, the board shall distribute all the remaining corporate assets among the shareholders according to their respective rights and preferences...*

The Creamery Board did receive an opinion from its corporate counsel advising such payments could be justified as being consistent with good business judgment. The attorney discussed two possible reasons that could justify such payments:

1. **It limits possible future litigation – providing more “finality.”** Such payments would bring greater finality to the corporation’s exit from the marketplace and lessen the likelihood of any producers suing MatMaid for payment.\(^{24}\) In the view of the corporate counsel such claims could arise from the legal theory of promissory estoppel where the courts sometimes make a non-contractual promise enforceable in the overall interest of justice.

2. **It would be consistent with maximizing return on the future disposition of assets.** If the intent was to sell or lease some or all of the assets to a prospective future dairy distributor, such payments may be necessary to sustain farmers until such time as a new entity was ready to buy raw milk. By sustaining dairy farmers with a type of severance, the corporation was more likely to get greater return on the disposal of its assets in the future.

We are not persuaded by the advice of the Creamery Board’s counsel on two major points:

1. **Preclusion of future litigation was not achieved since waivers were not obtained.** First, if the object of the payment was to preclude future litigation on the part of producers on the basis of promissory estoppel, the Creamery Board should have further directed that the payments be made contingent on the recipient producer formally waiving their future right to sue. No such waiver was obtained in exchange for the payments.

2. **Timing of payment was inconsistent with maximizing value of assets.** The potential that the payment would maximize return on future disposition of assets lacks support. There had already been one failed attempt to sell the dairy’s assets (property and equipment) as a whole. Parties with a stated interest in the purchase of the remaining property and equipment were not engaged in dairy operations. The newly formed private venture had already leased some of MatMaid’s equipment; however, the Creamery Board has made no assessment of the likelihood that the venture was actually financially viable. An

\(^{24}\) In the letter, the attorney did characterize the basis for any such lawsuit as “weak.”
assessment of this sort would be a reasonable precursor before distributing state assets to maintain the fundamentals of a dairy industry.

Authorizing payments totaling $39,000 to four individual dairy farmers from MatMaid assets is not consistent with the Creamery Board’s duties to its shareholder – ARLF.

**MatMaid financial records indicate sufficient assets to cover known liabilities and creditors**

As business operations come to an end, so have the receipt of revenues. However, MatMaid has collected most of the money due them and has used those funds to pay vendors owed. Most of the recorded accounts payable balance, as of the end of the year (See the Appendix A balance sheet), was owed to one vendor. At the end of February 2008, all known suppliers and creditors have been paid. As reflected by the summary schedule in Appendix B, MatMaid has an estimated cash balance of $166,000 as of the end of February 2008. A substantial receivable of almost $70,000 is still outstanding, and the Creamery Board has indicated it intends to vigorously pursue collection.

The property manager for ARLF conservatively estimates MatMaid’s remaining property, equipment, and rolling stock has a value of at least $1 million. The cash position of the corporation at the end of February 2008, and the underlying value of MatMaid equipment and rolling stock, indicates sufficient assets to pay known existing liabilities and creditors. Property located in Anchorage (on Northern Lights Boulevard) and in downtown Palmer on which MatMaid operated is owned by ARLF. The proceeds from any sale of these properties would not be used to fund future or unknown, MatMaid creditor claims.

Not included in this assessment of existing creditors is any potential liability or costs arising from two outstanding lawsuits against MatMaid alleging improper discharge and severance pay of two former executives.

**State executive who oversaw MatMaid’s closure was paid by the State, not the corporation**

Since August 2007, day-to-day management of MatMaid and wind-up has been carried out by a state official – a special assistant to the commissioner of Department of Commerce, Community, and Economic Development (DCCED). A substantial part of the special

---

25 Due to circumstances involved with the termination of the two executives, the risk of unrecorded liabilities is increased. For example, the Alaska School Activities Association (ASAA) is seeking to collect almost $46,000 from MatMaid receipts for a sponsorship agreement that was made in 2006. The collection letter from ASAA’s counsel has been referred to the Department of Law for resolution.

26 The Northern Lights property (land and building) has been appraised at just over $5.6 million. This value was based upon it being continued to be used as a creamery and distribution center. The appraiser concluded that discounting this use could have substantial negative impact on market value. The land at Northern Lights was appraised at just over $1.5 million, while the downtown Palmer property was put at $1.3 million.

27 DCCED’s commissioner office salaries are funded by general fund revenues and interagency receipts in the form of reimbursable service agreements. The special assistant stated to us that his temporary assignment to assist in the winding down of operations at MatMaid fell under his general job duties that primarily involved promoting economic development and diversification in the State of Alaska.
assistant’s time was dedicated to MatMaid, especially since the Creamery Board voted to close the operations. As MatMaid operations wound up, the special assistant has increasingly resumed his other duties as assigned within the commissioner’s office.

From our review of MatMaid expenditures, we saw no evidence this individual was compensated through the corporation. Rather, any compensation he received came through his capacity as a state employee. No detailed timekeeping records were kept of how the special assistant allocated his working time between MatMaid activities and DCCED activities. According to state payroll records and benefit costs, we estimate the total State personnel costs for this individual was more than $45,000 between September 2007 and February 2008. In our view a conservative estimate would be that MatMaid was subsidized by at least $25,000 for the efforts of the state executive.

This arrangement of loaning a state employee to MatMaid violates the legislative appropriation made to DCCED. Another complication stems from how the Office of the Commissioner within DCCED is budgetarily structured. All of the commissioner’s office costs are pooled and a percentage\(^{28}\) of those pooled costs are then allocated to the other agencies in the department. As a result, a portion of the costs for the special assistant are being distributed to other agencies within DCCED.

MatMaid equipment and rolling stock is accounted for and still sufficiently controlled

In preparation for the sale of MatMaid assets, the Division of Agriculture solicited bids for appraisal services to assess the value of MatMaid’s personal property and equipment (PPE). Three major components of PPE are the:

1. plant machinery used in processing dairy products;

2. manufacturing machinery used in making plastic milk jugs and clear plastic water bottles; in addition to the machinery used to fill the water bottles; and,

3. tractors and trailers used to haul and deliver product and packaging.

In October 2007, there was a complete inventory and valuation of MatMaid’s PPE. The PPE included items located at the Anchorage MatMaid processing plant, Palmer Blow Mold facility, and at the company’s cartage vendor’s place of business.\(^{29}\)

---

\(^{28}\) The commissioner’s office budget indicates over 70 percent of total costs will be charged off to other DCCED agencies.

\(^{29}\) Some of MatMaid’s rolling stock, such as tractors and trailers, were stored on the lot controlled by the corporation’s cartage service vendor.
During the November 2007 Board meeting, the PPE list attached to the sale was amended to remove leased, memorabilia/historical, office equipment, intellectual property, and items not owned by MatMaid.

Using the PPE appraisal as a basis, we conducted a physical inventory of MatMaid’s assets. We selected an extensive sample of items from the PPE appraisal and were able to locate those items with one major exception. Further, we confirmed the equipment described in the lease with the Southcentral Dairy Joint Venture were at that company’s facility.

Restrictions over loans for board members with ARLF have been observed

As discussed in the background information section, under state law, while serving on the board with oversight responsibility for ARLF loans, a board member has had certain restrictions put on their loan activity involving the fund. Prior to 2000, a board member was restricted from obtaining an ARLF fund either during their term on the board or one year after serving.

In 2000, legislation was passed establishing a new oversight board – the Board of Agriculture and Conservation (BAC), to administer ARLF. This statute put additional limits on BAC members’ access to ARLF loans, by restricting a board member, or an immediate family member of the board member from obtaining a new loan, or modifying or restructuring an existing agricultural loan.

Since FY 98, there have been seven board members who had active loans while serving on BAC. Exhibit 8 lists the individuals who – over the past ten years served on either BAC or the predecessor board responsible for ARLF oversight – had loans during their term on the board.

Exhibit 8

Members of the Board of Agriculture and Conservation or its Predecessor, the ARLF Board With Agricultural Revolving Loans During Tenure on Board FY 98 to Present

<table>
<thead>
<tr>
<th>Board Member – Board Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>John Schirack – June 2007 to present</td>
</tr>
<tr>
<td>Wayne Brost – June 2007 through September 2007</td>
</tr>
<tr>
<td>Bruce Willard – October 2004 through May 2007</td>
</tr>
<tr>
<td>Cyndie Warbelow-Tack – May 2005 through August 2005</td>
</tr>
<tr>
<td>Peter Fellman – August 2003 through August 2004</td>
</tr>
<tr>
<td>Harvey Baskin – September 2000 through May 2001</td>
</tr>
</tbody>
</table>

Source: Division of Agriculture, Agricultural Revolving Loan Records

30 Intellectual property includes three molds for making plastic milk jugs that imprint MatMaid logos.
31 A major piece of rolling stock – a tanker truck valued at $22,500 – was reportedly located in the state of Washington. The truck was used to haul raw materials for making milk jugs and plastic bottles. Accounting records indicate the truck was shipped south to transport back the necessary packaging raw materials. However, with the closure of MatMaid, the tanker truck was left in Washington since it was not considered cost effective to pay for shipping it back to Alaska empty. We could not confirm the truck was still under effective control of the State.
32 No ARLF board members had active loans during their terms.
None of these individuals obtained, modified, or restructured their loan during their term on the board. One board member had a loan modified prior to appointment on the board, due to a fire on the property which caused financial distress and resulted in their loan being classified as being in “moratorium” status while serving as an active member of the Board.33

Exhibit 9 lists individuals over the past ten years that have served on the Creamery Board while also having an ARLF loan. The first two individuals listed, with terms beginning in 2007, also simultaneously served on the BAC. As stated previously, while serving on the BAC, they were in compliance with the restrictions placed on their loan activities.

The last four individuals listed – which includes a separate, earlier term for Mr. Brost – served on the Creamery Board independent of BAC. All of these individuals had actions taken on their loans during their term on the Creamery Board that would have been prohibited had they been BAC (or in Mr. Hamilton’s case prohibitions related to the predecessor ARLF oversight board) members. As discussed, there is no prohibition or restriction on loan activity for any of these individuals in their capacity as Creamery Corporation directors independent of BAC.

---

33 An ARLF borrower may request a moratorium on an ARLF loan if the borrower suffers a financial disaster as defined by state regulation at 11 AAC 39.500. A moratorium allows a loan borrower to halt payments on a loan up to a period of time not exceeding one year, though interest still accrues.
April 14, 2008

Pat Davidson
Legislative Auditor
Alaska State Legislature
Legislative Budget and Audit Committee
Division of Legislative Audit
P.O. Box 113300
Juneau, AK 9811-3300

Via Facsimile (907) 465-2347

Re: Confidential Preliminary Audit Report on: Department of Natural Resources, Division of Agriculture, Agriculture Revolving Loan Fund, Matanuska Maid-Part 1, March 7, 2008

Dear Ms. Davidson:

Thank you for your letter dated March 25, 2008 transmitting the preliminary audit report referenced above. You requested in your letter a written and electronic response to those portions which concern the Department of Commerce, Community, and Economic Development ("DCCED").

The references to DCCED in the report are at the middle of page 15 and the bottom of page 24 continuing on until the middle of page 25. This discussion is focused on the use of a state employee to oversee the wind down of the affairs of Matanuska-Maid.

We are pleased that the report indicates that the state employee involved was assigned to these wind-down duties as a member of a task force established by Governor Palin to work with the Creamery Board. See Preliminary Audit Report at p. 15. The report notes that the DCCED employee served as a contact between the Governor’s task force, Matanuska Maid staff and the Creamery Board.

The report also notes that this employee informed the audit team that this temporary assignment "fell under his general job duties that primarily involved promoting economic development and diversification in the State of Alaska." See Preliminary Audit Report at p. 24, n. 27. We note that the audit team appears to have accepted this information so that the report's finding is that the DCCED special assistant was performing tasks involved with the Matanuska Maid wind-down that are part of his general job duties.

We agree with the statements at page 25 of the preliminary audit report that the DCCED employee was always paid in "his capacity as a state employee." See
Preliminary Audit Report at p. 25. This is consistent with the fact that he was performing tasks consistent with his general job duties. Id. at p. 24, n. 27.

We concur that no detailed timekeeping records were kept of how this employee allocated his time between Matanuska Maid work and his work at the Office of Economic Development within DCCED. Generally, state employees assigned to tasks within the scope of their general job duties do not maintain records of time spent on any particular project or assignment. Therefore, we agree with this finding because it supports the conclusion that the employee was at all times assigned to state related work.

The preliminary audit report then at page 25 estimates the total state personnel costs of this individual between September 2007 and February 2008. From this estimate, the report then extrapolates a figure that Matanuska Maid was “subsidized by at least $25,000 for the efforts of the state executive.” Id.

DCCED disagrees with this characterization. While the salary involved was approximately $45,000 for the time period chosen and used in the preliminary audit report, there is no logical nexus between that fact and the report’s assertion that Matanuska received a “subsidy”. Matanuska Maid did receive services and those services have value, but the services provided were within the job duties of the state employee.

Further, the Office of the DCCED Commissioner is funded both from assessments to DCCED divisions and General Fund sources. It is our view that no divisions within DCCED were assessed for Mr. Austerman’s time or his salary. Mr. Austerman was part of the Office of the Commissioner. The Office of the Commissioner has General Funds allocated for its use so that no DCCED divisions were assessed specifically with the costs associated with Mr.Austerman’s time working on this Task Force.

We thank you for this opportunity to comment.

Respectfully,

[Signature]
Emil Notti
Commissioner
SARAH PALIN, GOVERNOR

P.O. BOX 111000
JUNEAU, ALASKA 99811-1000
PHONE: (907) 465-2400
FAX: (907) 465-3886

550 WEST 7TH AVENUE, SUITE 1400
ANCHORAGE, ALASKA 99501-3650
PHONE: (907) 269-8431
FAX: (907) 269-8918

APRIL 11, 2008

LEGISLATIVE AUDIT

STATE OF ALASKA

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF THE COMMISSIONER

Legislative Auditor
Division of Legislative Audit
PO Box 111000
Juneau, AK 99811-100
Attn: Pat Davidson, CPA

Re: Legislative Audit of Matanuska Maid, Part 1, Audit Control Number 10-30049A-08

Dear Ms. Davidson:

Thank you for the opportunity to provide a written response to the March 7, 2008 preliminary audit on the Department of Natural Resources, Division of Agriculture, Matanuska Maid-Part 1.

We have reviewed the report and offer the following responses and comments to the following sections:

ORGANIZATION AND FUNCTION

The Department of Natural Resources is currently organized into eight divisions that reflect the major programs: (1) Agriculture; (2) Coastal and Ocean Management; (3) Forestry; (4) Geological and Geophysical Surveys; (5) Mining, Land, and Water; (6) Oil and Gas; (7) Parks and Outdoor Recreation; and (8) Support Services.

BACKGROUND INFORMATION

As task force recommends, Creamery Board seeks to sell MatMaid intact to another operator

In September 2007, pursuant to AS 10.06.570, the Creamery Board sought shareholder approval to sell all, or substantially all, of its assets. The BAC approved this request at its September 9, 2007 meeting. The BAC believed it was in the best interest of the State to offer for sale the entire MatMaid operation, including real property, in order to attract bidders who could continue processing milk in Alaska. Offering the entire MatMaid operation for sale also allowed individuals who were only interested in parts of the operation to join efforts and submit one bid for the entire operation. Before publishing the notice soliciting bids, the BAC held a public hearing and made written findings in a decisional document.

The hearing provided the public with an opportunity to submit oral or written comments regarding the proposed sale of all, or substantially all, of the personal property currently owned by MatMaid and the real property owned by the ARLF. The decisional document addressed comments received

"Develop, Conserve, and Enhance Natural Resources for Present and Future Alaskans"
and set forth the BAC’s justification for conducting the sale in the manner proposed. The proposal deadline was in December 2007. No proposals were received.

On February 26, 2008, by written consent, the BAC elected to dissolve the corporation and wind up its affairs.

REPORT CONCLUSIONS

Payment to dairy farmers inconsistent with Board’s corporate responsibilities.

With regard to any use of the $600,000 appropriation to pay dairy farmers, on January 15, 2008 the Creamery Corporation passed a motion to pay South Central Dairy Farmers for milk that had been disposed of because of the closure of MatMaid. The payments were to be paid from the $600,000 appropriation. The Creamery Board felt that the expenditure fell within the guidelines of that appropriation as interpreted by the December 21, 2007 letter written by President of the Senate, Lyda Green to Department of Natural Resources Commissioner Tom Irwin.

Commissioner Irwin had responded to Senator Greens by letter dated January 11, 2008. Commissioner Irwin stated that “…it appears that DNR is without legislative authority to spend the appropriation other than for “the assistance of the Creamery Corporation”.”

On January 16, 2008, the DNR notified the Creamery Corporation that “[i]t is the position of the Department of Natural Resources, as advised by the Department of Law, that such expenditure does not fall within the guidelines of this appropriation. Since the appropriation is to DNR you are hereby notified that we do not authorize any expenditure of this appropriation for payment of milk that has been or will be disposed.”

Expenditures authorized by the Creamery Corporation that do not involve the $600,000 appropriation do not fall under DNR’s administrative oversight of the appropriation to DNR and are the responsibility of the Creamery Corporation.

The dairy payments made by the Creamery Corporation from its own revenues are subject to general corporate law governing business decisions. Under business judgment rule, the law presumes that in making a business decision the directors act on an informed basis, in good faith, and in the honest belief that the action taken is in the best interests of the corporation. This presumption is overcome only upon a showing of bad faith or self-dealing. Under the business judgment rule, “courts will not second-guess the actions of directors unless it appears that they are the result of fraud, dishonesty or incompetence.” As such, the business judgment rule shields directors from liability for unprofitable or harmful corporate transactions. Section 1470 of American Jurisprudence 2d describes the rule as follows:

1 18B Am. Jur. 2d Corporations §1470.
2 Bennett v. Weimar, 975 P.2d 691, 697 (Alaska 1999) citing Schwarzmann v. Ass’n of Apartment Owners, 655 P.2d 1177, 1181 (Wash. App. 1982) (holding that a court will not second-guess actions of directors absent a showing of fraud, dishonesty, or incompetence, and that directors could not be held personally liable without a showing that they acted in bad faith or knowingly condoned wrongful or negligent conduct).
3 18B Am Jur. 2d Corporations §1470.
Procedurally, the business-judgment rule creates an evidentiary presumption that, in making business decisions not involving self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation’s best interest. Substantively, the business judgment rule insulates an officer or director of a corporation from liability for business decisions made:

1. in good faith;
2. where the director or officer is not interested in the subject of the business judgment;
3. where the director or officer is informed with respect to the subject of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and
4. where the director or officer rationally believes that the business judgment in question is in the best interests of the corporation. 4

Absent a showing of fraud or self-dealing, a director’s actions and judgment will not be second-guessed by a court. Absent such a showing, courts presume that directors acted in good faith and with due care.

We appreciate the opportunity to comment on the audit report. The courtesy and professionalism shown by the audit staff in the conduct of this review is respected. Please let us know if you have any further questions or wish additional comment.

Sincerely,

Dick LeFebvre
Deputy Commissioner

cc: Leta Simons, Director, DNR Support Services Division
Christina Otto, Department of Law

---

4 18B Am Jur. 2d Corporations §1470.
April 14, 2008

Legislative Auditor
Division of Legislative Audit
PO Box 111000
Juneau, AK 99811-100
Attn: Pat Davidson, CPA

Re: Legislative Audit of Matanuska Maid, Part 1,
Audit Control Number 10-30049A-08

Dear Ms. Davidson:

Thank you for the opportunity to provide a written response to the March 7, 2008 preliminary audit on the Department of Natural Resources, Division of Agriculture, Matanuska Maid-Part 1.

We have reviewed the report and offer the following responses and comments to the following sections.

The Creamery Corporation, also referred to herein as MatMaid, offers its response to the following section:

BACKGROUND INFORMATION

In 2005 operating losses at MatMaid began to accumulate

The audit report states that the Creamery Corporation’s operating losses for 2005 amounted to $282,000. The Creamery Corporation’s audited financial statement for 2005 shows a loss, before income tax adjustments, of $282,413 and after tax loss of $179,590. The Creamery Corporation’s unaudited 2006 financial information shows an operating loss of $550,675 and a total net loss of $693,681.
Legislature appropriated $600,000 to facilitate MatMaid’s operational shutdown

The Creamery Corporation would like to add the following background information to explain how and why MatMaid expended the $600,000 appropriation in the manner in which it did.

The audit report fails to provide the actual language of the appropriation bill which reads as follows: “The sum of $600,000 is appropriated from the general fund to the Department of Natural Resources for assistance to The Creamery Corporation, dba Matanuska Maid.” Based upon this language, the Creamery Corporation requested that the DNR disburse these funds to MatMaid to cover ongoing expenses such as personnel expenses. MatMaid, like many businesses, maintains one checking account and the appropriation was deposited into this account. MatMaid only used these funds to cover ongoing business expenses as provided below:

<table>
<thead>
<tr>
<th>MAT MAID SOURCES AND USES OF FUNDS</th>
<th>January 1, 2008 to February 29, 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>Cash Balance January 1, 2008</td>
<td>696,644.00</td>
</tr>
<tr>
<td>Cash Deposits</td>
<td>866,807.79</td>
</tr>
<tr>
<td><strong>Cash Disbursements</strong></td>
<td></td>
</tr>
<tr>
<td>Personnel</td>
<td>534,098.92</td>
</tr>
<tr>
<td>Buildings</td>
<td>120,597.45</td>
</tr>
<tr>
<td>Supplies</td>
<td>106,716.19</td>
</tr>
<tr>
<td>Transportation</td>
<td>547,866.86</td>
</tr>
<tr>
<td>Legal and Audit</td>
<td>48,860.52</td>
</tr>
<tr>
<td>Payment to producers</td>
<td>39,267.20</td>
</tr>
<tr>
<td>Total Disbursements</td>
<td>1,397,407.14</td>
</tr>
<tr>
<td>Balance</td>
<td>166,044.65</td>
</tr>
</tbody>
</table>
Governor Palin removes old governing board, appoints all new members to BAC

MatMaid would like to add the following information by way of background to further explain the actions taken by the new Creamery Corporation Board of Directors ("Creamery Board") in reviewing MatMaid operations. When the new Creamery Board took over management of MatMaid, it elected to continue regular operations at MatMaid for a period of time, funded with the addition of the $600,000, for the purpose of determining if there could be another plan developed within 90 days. In so acting, the Creamery Board sought to take a fresh look at MatMaid and to examine all possible options. The Board appointed six members to serve on a Task Force to review all options while the Board looked for ways to cut costs, increase sales, and put the company back in the black.

During the 90-day review period, the Creamery Board reviewed the 1998 Legislative Audit and its recommendations, Mat Maid Privatization White Paper from October 2005, the Alaska Dairy Ad Hoc Committee recommendations from November 2006, and the Mat Maid Task Force report from August 2007. In October of 2007, the Creamery Board also contracted with Mikunda, Cottrell & Co., Inc. to review the business practices of MatMaid for the period January 1, 2005 through June 30, 2007. This report, completed in December 2007, documented excessive discretionary spending on the part of MatMaid President/CEO and the Palmer Plant Manager, which contributed to the precipitous decline of the business. The report also found that MatMaid operated without a mandate and lacked precise objectives.

During this period of review, the cost of milk continued to escalate. The price of milk increased all over the world, and yet, MatMaid was subject to a 30 day notice requirement before it could raise its prices. As such, MatMaid continued to lose money because it could not respond quickly enough to the increases in milk prices. Without additional capital, MatMaid was unable to sustain itself through these price increases and could not hold out for milk prices to drop. The Creamery Board also considered the viability of producing an "all Alaskan Product." However, the lack of capital, the relatively low volume of local milk available, coupled with the large volume capacity of the MatMaid facility, did not make this a profitable option. Overall, the Creamery Board conducted a comprehensive review of the current and alternative business models before deciding to shut down MatMaid’s operations.

State executive was assigned to oversee day-to-day operations during shutdown

MatMaid would like to add the following background information to explain why the special assistant to the Commission of the Department of Commerce, Community and
Economic Development ("DCCED") began to oversee day-to-day operations of MatMaid.

At the end of May 2007, the then President and CEO of MatMaid submitted his letter of resignation, effective June 30, 2007, to the prior Creamery Board. In June 2007, this same Creamery Board voted to wind up MatMaid operations and to cease milk production on July 7, 2007. In light of the imminent closure of the dairy and water bottling operation, the Creamery Board rejected the MatMaid President and CEO’s resignation. However, the Creamery Board and the MatMaid President and CEO subsequently came to an agreement whereby he would stay on through the end of August 2007 to provide an orderly and dignified shutdown of operations. The current Creamery Board, appointed in late June, 2007, met with the MatMaid President and CEO shortly after being seated and before becoming acquainted with his management of MatMaid. Despite the Creamery Board’s request at that time that he stay on beyond August 31, 2007, the MatMaid President and CEO expressly refused to do so.

Because the MatMaid President and CEO made it clear that he had no intention of staying beyond August 31, 2007, the Creamery Board determined that it would need an interim manager. Given the uncertainty of MatMaid’s future, the Creamery Board recognized the difficulty in hiring a new President and CEO and instead sought the assistance of the task force liaison, special assistant to the Commissioner of DCCED, to oversee management of MatMaid. While the task force liaison did perform services for MatMaid, this work was in addition to, not in place of, his work as special assistant to the Commissioner of DCCED.

As task force recommends, Creamery Board seeks to sell MatMaid intact to another operator

MatMaid would like to add the following information by way of background to further explain the actions taken by the Creamery Board in electing to sell MatMaid. In response to the Task Force’s recommendations and the Creamery Board’s independent review of MatMaid, on August 28th the Creamery Board recommended to the Governor to not just close MatMaid but to also work toward transitioning the dairy into the private sector. In a press release dated August 29, 2007, the Governor accepted the Creamery Board’s recommendation to transition MatMaid into the private sector. Following this announcement, the Creamery Board, together with the BAC, sought to dispose of all, or substantially all, of MatMaid’s assets and the ARLF owned real property together under one offer.

In electing to dispose of all assets together, MatMaid sought to implement the Task Force’s recommendation of allowing private enterprise to take Alaskan dairy products
into the future. Because the Creamery Board, together with the BAC, sought to sell all corporate and state owned property together in one offering, the entire sale went out for public notice and bid. Prior to the sale, the BAC authorized the Creamery Board to sell all or substantially all of its assets and held a public hearing. No bids were received.

At the end of February 2008 the BAC, as shareholder, formally elected to dissolve MatMaid. Having already authorized the Creamery Board to sell all, or substantially all of its assets, the Creamery Board continues winding up MatMaid’s affairs, disposing of its assets and paying undisputed creditor claims.

The Creamery Corporation offers its response to the following section:

**REPORT CONCLUSIONS**

**Creamery Corporation appropriately pays federal and state corporate income tax.**

The Creamery Corporation agrees with the audit’s conclusion that MatMaid is subject to federal and state income tax. This is true not only because MatMaid does not perform an essential governmental function, but also because MatMaid’s revenues do not accrue to the State. The Department of Revenue does not collect or hold under its custody any Creamery Corporation revenues. The Creamery Corporation, having been incorporated under the Alaska Corporation Code, is an entity, separate and distinct from its officers and shareholder. The Creamery Corporation, like any corporation, acts through its officers and shareholders, but it is the corporate entity that is legally responsible for those acts and it is the corporate entity which is subject to taxation.

**Payment to dairy farmers inconsistent with Board’s corporate responsibilities.**

The audit report concludes that the modest payment made by the Creamery Board to four longtime area milk producers was “inconsistent with the board’s corporate responsibilities” and inconsistent with “the financial interest of the corporate shareholder[.]” MatMaid disagrees with this conclusion for the following reasons.

The audit report, while concluding that the Creamery Board’s action was inconsistent with its corporate responsibilities, fails to even explain which fiduciary duty the board allegedly breached. The two fiduciary duties owed by the Creamery Board to the corporation, neither of which were breached, are the duty of care¹ and the duty of loyalty.²

---

¹ AS 10.06.450(b).
² AS 10.06.478.
As to the duty of loyalty, a director is obligated to avoid self-dealing, conflicts of interest, and faithlessness to the corporation. The Creamery Board directors did not financially benefit from the payment. There was no self dealing or bad faith in making this payment. In electing to support the dairy industry, the Creamery Board did not breach its duty of loyalty to the corporation. The only other duty owed by the directors to the corporation is the duty of care.

As to a director’s duty of care, directors shall perform their duties “in good faith, in a manner the director reasonably believes to be in the best interests of the corporation, and with the care, including reasonable inquiry that an ordinarily prudent person in a like position would use under similar circumstances.” In exercising this duty of care, directors may rely upon information and opinions from officers, employees, legal counsel, accountants or other persons that the directors reasonably believe to be reliable and competent.

In deciding to make the one-time payment, the Creamery Board exercised due care. The Creamery Board’s decision was made over the course of several board meetings and nearly two months. In making its decision the Creamery Board relied upon information and opinions from counsel and others. The December 7, 2007 letter quoted from in the audit report was only one such opinion relied upon by the board. The Creamery Board’s action was based upon a good faith belief that it was the right thing for the agricultural industry and ultimately for the shareholder.

The Creamery Board’s election to pay the total sum of $39,267.00, split between four different area milk producers in order to allow them to maintain their herds while an alternative processing facility was completed, was a legitimate exercise of its discretionary authority and consistent with prevailing corporate norms. This emergency

---

3 18B Am. Jur. 2d Corporations §1480 ("The duty of loyalty to the corporation imposed on its officers and directors includes the duty to avoid conflicts of interest. The duty of loyalty also prohibits faithlessness and self-dealing.").
4 AS 10.06.450(b).
5 AS 10.06.450(b)(1) and (2).
6 The audit report quotes language from a letter from corporate counsel to the Board of the Creamery Corporation dated December 7, 2007, in support of the proposition that the payment under discussion here was based upon a rationale which later proved to be erroneous. The auditor’s reliance upon this letter is somewhat perplexing, inasmuch as that letter addressed concerns arising in conjunction with a proposal considered and later rejected by the board involving the creation and funding of a far larger “severance” payment program for area milk producers. That proposal was never adopted. There is absolutely no link between the two payment plans, one of which was implemented and
payment derived from revenues generated by the continuing operations of MatMaid, rather than from the $600,000 appropriation.

The Creamery Board determined that it was best to proceed as soon as possible in making the payment. It did so on the basis of its strong belief that it should act in a responsible and timely manner, using MatMaid revenues, to do anything within its power to preserve at least the potential for the continuation of a self-sustaining dairy operation in the State. At the time various persons and entities were actively pursuing dairy-related ventures in Southcentral Alaska. The destruction of the local dairy herds would have effectively nullified all of these efforts. The Creamery Board looked carefully at the economic and operational implications associated with the loss of the area’s milk-producing capability. All of the ventures working to bring new facilities on-line would have, absent the availability of local product, halted their activities, leading to significant economic waste and the end of any realistic hope, now or in the future, of re-establishing a domestic, integrated dairy industry.

The collateral damage associated with the destruction of the dairy industry would have also extended to those businesses which have traditionally acted as suppliers to the dairies, most notably local feed producers. The ARLF extends loans not only to the dairy industry, but also to the local feed and grain producers. As such, the collapse of the dairy industry would have resulted not only in defaults on ARLF dairy loans, but also on ARLF loans throughout the agricultural industry. The Creamery Board carefully considered all of these factors when determining that it was in the best interest of corporation and the shareholder to authorize this one-time payment.

Finally, the audit fails to discuss that under the business judgment rule, the law presumes that in making a business decision directors act on an informed basis, in good faith, and in the honest belief that the action taken is in the best interests of the corporation. This presumption is overcome only upon a showing of bad faith or self dealing. Under the business judgment rule, “courts will not second-guess the actions of directors unless it appears that they are the result of fraud, dishonesty or incompetence.”

---

7 18B Am. Jur. 2d Corporations §1470.
8 Bennett v. Weimar, 975 P.2d 691, 697 (Alaska 1999) citing Schwarzmann v. Ass’n of Apartment Owners, 655 P.2d 1177, 1181 (Wash. App. 1982) (holding that a court will not second-guess actions of directors absent a showing of fraud, dishonesty, or incompetence, and that directors could not be held personally liable without a showing that they acted in bad faith or knowingly condoned wrongful or negligent conduct).
judgment rule shields directors from liability for unprofitable or harmful corporate transactions, so long as the business decision does not involve self-dealing and so long as corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation’s best interest.\(^9\)

Absent a showing of fraud or self-dealing, a director’s actions and judgment will not be second-guessed. The Creamery Board’s decision to pay dairy producers, some of whom had outstanding ARLF debts and all of whom supported the agricultural industry, did not constitute fraud or self-dealing. None of the individual board members profited from the payment or had “a material financial interest”\(^{11}\) in the transaction. As such, the law presumes that the directors, in electing to make the payment, acted in good faith and with due care. The Creamery Board properly exercised its discretionary authority in making this modest, one-time payment to four area milk producers who were otherwise in danger of losing their herds.

State executive who oversaw MatMaid’s closure was paid by the State, not the corporation.

The special assistant did not dedicate his time solely to MatMaid. While overseeing the management of MatMaid, the special assistant continued to perform DCCED assigned tasks. The special assistant’s work for MatMaid was in addition to, not in place of, his DCCED work. Finally, the special assistant frequently performed work for MatMaid in the evenings and on the weekends.

MatMaid equipment and rolling stock is accounted for and still sufficiently controlled

The resin tanker remains located in Tacoma, Washington and will be included within the liquidation sale.

---

\(^9\) 18B Am Jur. 2d Corporations §1470.
We appreciate the opportunity to comment on the audit report. The courtesy and professionalism shown by the audit staff in the conduct of this review is respected. Please let us know if you have any further questions or wish additional comment.

Sincerely,

Kristan Cole
President and Chair
Creamery Corporation
Members of the Legislative Budget and Audit Committee:

We have reviewed the responses of the Department of Commerce, Community and Economic Development, the Department of Natural Resources, and the Creamery Corporation to the audit report. While we have made the correction to the Organization and Function noted by the Department of Natural Resources, nothing contained in the responses give us cause to reconsider our conclusions. However, there is one point that we wish to clarify.

In the response from the Department of Commerce, Community and Economic Development they state:

"The report also notes that this employee informed the audit team that his temporary assignment "fell under his general job duties that primarily involved promoting economic development and diversification in the State of Alaska." ... We note that the audit team appears to have accepted this information so that the report’s finding is that DCCED special assistant was performing tasks involved with the Matanuska Maid wind-down that are part of his general job duties."

The audit team did not agree with that explanation and our conclusion is that, "This arrangement of loaning a state employee to MatMaid violates the legislative appropriation made to DCCED."

In summary we reaffirm the report conclusions.

Pat Davidson, CPA
Legislative Auditor
Division of Legislative Audit