

SUMMARY OF CAPITAL CREDITS LITIGATION

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Several class action lawsuits have been filed against electric cooperatives across the country relating to the handling of capital credits of their current and former members. Allegations range from failure to retire capital credits, failure to notify patrons, and outright fraudulent concealment of member capital to waste of corporate assets and election improprieties. It is clear that class action attorneys have identified electric cooperatives as a potentially vulnerable and lucrative target.

The attorneys at Autry, Horton & Cole, LLP created this summary to alert electric cooperatives to the potential risk of these lawsuits so that they may take appropriate action to mitigate risks and avoid pitfalls, and, if necessary, defend themselves. AHC has represented cooperatives for decades in all areas of cooperative law, and it specializes in cooperative taxation, power transactions and related contractual arrangements, corporate matters, and state and federal regulation. We hope this summary is informative as well as useful.

Litigation Summary and Status Update

Class action attorneys have sued cooperatives in Alabama, Arkansas, Georgia, Missouri, North Carolina, New Mexico, South Carolina, and Texas. They are pending in state and federal courts, along with a public utility commission. While some lawsuits have been dismissed or settled, most are currently in active litigation. Two have resulted in appellate decisions, but only one of those addressed the merits of the claims.

ALABAMA

Recherche, LLC v. Baldwin County Electric Membership Corporation and Harkless v. Dixie Electric Cooperative

The most recent lawsuits were filed in Alabama against Baldwin County Electric Membership Corporation and Dixie Electric Cooperative. In both lawsuits, putative classes of current and former members assert a claim for breach of contract and seek declaratory and injunctive relief related to handling of capital credits.

Both complaints rely on an Alabama statute that ostensibly requires annual retirement of capital credits. The plaintiffs allege that the cooperatives have failed to comply with this statute because they do not retire capital credits on an annual basis. With regard to former members, the plaintiffs argue that the cooperatives' long capital rotation periods effectively result in forfeiture of capital credits because many former members have moved away or died.

The plaintiffs in both cases seek court orders:



- declaring that the relevant statute requires annual retirement
- finding that the cooperatives have failed to comply with the statute
- requiring the cooperative to comply with the statute

In addition, they assert a breach-of-contract claim arguing that the cooperatives violated their bylaws. The claim relies on the principle that the bylaws must be construed in a manner to comply with the statute – requiring annual retirement.

The two cases remain pending.

ARKANSAS

Capps v. Carroll Electric Cooperative Corp.

A group of current and former members sued Carroll Electric Cooperative Corp. arguing that the cooperative wrongfully failed to retire capital credits. The lawsuit began in the Circuit Court of Benton County and has ended up in the Supreme Court of Arkansas and the Arkansas Public Service Commission (“APSC”).

The plaintiffs originally filed their lawsuit in the Circuit Court of Benton County alleging that:

- The cooperative has over \$170 million in patronage capital, but does not return capital credits to former members and does not return excess capital to current members.
- The cooperative has not retired any capital credits since 1998 and has retired only about \$12.6 million since its formation in 1937.
- The cooperative has failed to distribute capital credits that it receives from cooperatives in which it holds an equity interest, such as the G&T, of which the cooperative is a member.
- The cooperative’s board of directors uses the cooperative’s funds as a “private till,” and its corporate controls are “inadequate and fraught with potential for abuse.”
- The cooperative concedes in its internal policies and annual reports that it can retire about 5% of its outstanding capital credits per year but has failed to do so.



- The cooperative has an inordinately high equity-to-asset ratio relative to comparable electric cooperatives, indicating that it can and should be retiring capital credits.
- The cooperative is violating an internal policy which provides that the cooperative will retire capital credits at a rate of 5% per year or on a 20-year retirement cycle, whichever is greater.
- The cooperative has failed to distribute notices of allocation for over a decade.
- The cooperative's notice in 2009 that it would not retire any capital credits of members or former members fails to adequately explain why no retirements were made and does not provide any notice of allocation.
- The cooperative's actions violate the cooperative principles, and democratic control by the members has been undermined.
- The board of directors has acted in violation of the bylaws and has breached its fiduciary duties.
- Members of the board do not live in the districts that they represent.

The complaint sought various forms of relief, including:

- an order requiring the cooperative to retire capital credits on a reasonable and systematic basis
- an order requiring the cooperative to provide putative class members with an accounting of capital credit accounts
- interest, costs of suit, attorney fees, and punitive damages

The plaintiffs' claims include alleged violations of the state electric cooperative act, claims for declaratory and injunctive relief, and claims of conversion, breach of fiduciary duty, breach of contract, oppression, and unjust enrichment.

In its complaint, the plaintiffs reference NRECA's Capital Credits Task Force Report, statements from a financial advisor to the cooperative made in public hearings in 1999 and 2000, written materials from other cooperatives concerning capital credits, treatises on cooperatives, and Congressman Jim Cooper's policy essay about the improper operation and practices of electric cooperatives.



In response to the complaint, the cooperative filed a motion to dismiss all claims for monetary relief, arguing that the APSC had jurisdiction over such claims. The trial court agreed and dismissed the case. The plaintiffs appealed the dismissal to the state's Supreme Court. The Supreme Court affirmed the dismissal because, in essence, the claim arose from alleged violations of the Arkansas electric cooperative enabling act, which the APSC had jurisdiction to resolve.

More information about the dismissal and the Arkansas Supreme Court's opinion is available on [AHC's Cooperative Law Blog](#), including the post entitled "Capital Credit Litigation Update: Court Affirms Dismissal of Capital Credit Lawsuit," which can be found at <http://ahclaw.com/cooperative/?p=113>.

Schumacher v. Carroll Electric Cooperative Corp.

Upon dismissal of its first lawsuit, the plaintiffs filed a second complaint against the cooperative and several officers and board members with the Arkansas Public Service Commission. The complaint seeks declaratory and injunctive relief and asserts claims for breach of fiduciary duty, breach of contract, and unjust enrichment. The complaint alleges that the defendants:

- violated Arkansas statutory law and common law, as well as Carroll Electric's articles of incorporation and bylaws
- systematically concealed members' capital credits and failed to provide notice of allocations
- paid excessive compensation and benefits
- undermined true democratic control by, among other things, failing to provide members with records and access to meetings
- diminished the value of members' capital credits by imposing strict limitations and parameters for a sale of the cooperative at fair value
- in violation of a board policy, refused to distribute patronage capital it received from the G&T cooperative from which it acquires power at wholesale
- violated the bylaws by improperly spraying herbicides on rights-of-way



More information about the new complaint is available on AHC's Cooperative Law Blog, including the post entitled "Class Action Continues Before State Public Service Commission," which can be found at <http://ahclaw.com/cooperative/?p=257>.

In response, the cooperative asserts a number of defenses and rebuttals, including:

- The APSC's jurisdiction is limited to claims involving capital credits; all other claims are based in private rights of action over which the APSC has no jurisdiction.
- The APSC does not have authority to grant the requested remedies, except those relating to capital credits.
- The cooperative has properly retired capital credits.
- Under Arkansas law, claims of breach of contract and unjust enrich are mutually exclusive claims.
- The claims are barred by the doctrines of res judicata and collateral estoppel.

As a preliminary matter, the APSC considered whether it has jurisdiction over the plaintiff's claims. Upon reviewing statutory provisions establishing and limiting its jurisdiction and authority, on September 18, 2012, the APSC issued an order declaring:

- It has no jurisdiction over the plaintiff's claims, except for those concerning the return of capital credits.
- It has no authority to award damages or attorney fees.

Importantly, the APSC also declined to certify the proposed class of plaintiffs. It reasoned that any relief it may award concerning capital credits would also extend to all other non-class members of the cooperative. While the matter is still pending before the APSC, the scope and magnitude of remedies available against the cooperative has been significantly narrowed and potentially diminished.



GEORGIA

Shea v. Cobb Electric Membership Corporation

Former members of Cobb EMC brought a class action suit on January 15, 2010, seeking declaratory and injunctive relief and asserting claims for breach of fiduciary duty, breach of contract, unjust enrichment, and fraudulent concealment.

The complaint alleges, among other things, that:

- Cobb EMC uses its current earnings to make rebates to current members rather than retiring capital credits to former members.
- Cobb EMC violated cooperative principles and its duties by failing to systematically revolve its patronage capital.
- Cobb EMC has never adopted a revolving plan and has not made a capital credit retirement in over 40 years.
- The board of directors abused its discretion by refusing to retire any capital credits of former members.
- Preferring current members over former members by spending \$38 million on rebates to current members exploits the capital of former members to subsidize the electric rates of current members.
- Cobb EMC's actions constituted a conflict of interest and a breach of fiduciary duties owed to former members with respect to their unretired capital credits.
- Cobb EMC has misused millions of dollars that could have been used to retire the capital accounts of former members by spending funds on self-dealing transactions and by refusing to consider a buyout offer from a major investor that would have returned approximately \$300 million to current and former members.
- Cobb EMC has failed to pay interest on capital credits of former members.

The plaintiffs seek various forms of relief, including:

- the return of approximately \$150 million in capital credits owned by former members



- punitive damages, interest and attorney fees
- an order requiring Cobb EMC to return capital of former members and cease the practice of refunding current-year margins to current members before restoring capital of former members
- an order appointing an independent trustee over former members' capital credits

Plaintiffs' pleadings include references to the other lawsuits involving Cobb EMC, including depositions, and newspaper articles concerning the other litigation. The plaintiffs also refer to the sheriff's affidavit in support of a search warrant for the residence of the CEO and board members.

Cobb EMC has filed a motion to dismiss the action based in part on the following arguments:

- The bylaws expressly grant the board discretion as to when to retire capital credits.
- No fiduciary duty is owed by Cobb EMC to the former members.
- Even if a fiduciary relationship exists, the business judgment rule applies as a complete defense.
- Unjust enrichment is not a valid claim because an express contract exists and because Cobb EMC has not received any benefit.
- The claim of fraudulent concealment fails because there is no scienter – or fraudulent intent – and because no duty exists to disclose information to former members.
- Statutes of limitation bar most of the claims.

In its response, the plaintiffs argue that a fiduciary relationship does in fact exist between Cobb EMC and its former members, and that the business judgment rule is not a defense to a claim for breach of fiduciary duty.

Moreover, the plaintiffs moved the court for an order requiring Cobb EMC to disclose any plans to retire capital credits. In response, Cobb EMC identified a policy, dated September 27, 2011, to retire capital credits without impairing its financial condition or violating contractual covenants, and argues that the policy renders the entire lawsuit moot.



The plaintiffs countered that the policy does not moot the lawsuit because the cooperative is at liberty to ignore the policy, and the policy does not bind Cobb EMC to return capital credits on a reasonable rotation cycle.

With respect to these motions, both parties have filed several briefs, responses, replies, and sur-replies, and await the court's rulings. The case remains pending.

MISSOURI

Burks v. White River Valley Electric Cooperative

Plaintiffs in Missouri filed a lawsuit against White River Valley Electric Cooperative alleging that the cooperative has failed to retire capital credits. So far the case has been litigated in three separate courts (due to motions to transfer venue by both parties) and has been voluntarily dismissed twice. It remains to be seen whether the plaintiffs will refile the case.

The original lawsuit asserted claims of conversion, breach of fiduciary duty, breach of contract, oppression, unjust enrichment, and violation of the state's unfair trade practices act, and sought declaratory and injunctive relief. The putative class included current and former members of the cooperative. The plaintiffs voluntarily dismissed their first lawsuit without prejudice.

The second complaint, filed in Greene County, Missouri, added as a defendant a G&T cooperative, Associated Electric Cooperative, Inc., along with a claim of civil conspiracy. In essence, the new claim asserts that White River Valley and Associated Electric, along with other entities, conspired to improperly retain patronage capital, depriving the plaintiffs of capital credits to which they were entitled. Unlike the first complaint, the second action does not include current members as part of the putative class.

The plaintiffs allege that:

- The cooperative does not return capital credits to former members and does not return excess capital to current members.
- The cooperative has not retired any capital credits in over two decades.
- The cooperative has an inappropriately high equity-to-asset ratio, indicating that it can and should be retiring capital credits.
- The cooperative is treating former members and longstanding members inequitably by using their capital for the current operation of the cooperative.

The plaintiffs seek various forms of relief, including:



- An order requiring the cooperative to retire capital credits on a reasonable and systematic basis.
- An order requiring the cooperative to provide class members with an accounting of capital credit accounts.
- Interest, costs of suit, attorney fees, and punitive damages.

For a second time in this matter, the plaintiffs voluntarily dismissed their complaint without prejudice in March 2011. At this time, no additional complaint has been filed.

NEW MEXICO

The Socorro Electric Cooperative, Inc. v. West

One of the more peculiar cases arises from the dispute between Socorro Electric and its members. The lawsuit began as a class action filed *by the cooperative* against its members after members approved a bylaw provision that required the cooperative to comply with certain open-meetings and open-records laws of New Mexico.

At the annual meeting on April 17, 2010, the members approved a bylaw provision stating:

- that meetings of the board of trustees “shall be open to the member/owners and representatives of the press with timely notice”
- that the cooperative “voluntarily agrees to abide by the Open Meeting Act and Inspection of Public Records Act”
- that the cooperative and the board of trustees “shall guarantee Transparency of actions with open access to [cooperative] books, records, [and] audits to members, for proper, non-commercial purposes”

The cooperative alleges that the bylaw changes would prevent the board from effectively carrying out the business of the cooperative and would prevent it from meeting its obligations to the members. Accordingly, the cooperative seeks a declaratory judgment stating:

- the members had no authority to adopt the bylaw changes
- the bylaw changes are void as a matter of law



- the cooperative need not comply with the open-meeting and open-records laws
- the members are enjoined from enforcing the bylaw changes
- award attorney fees and costs

In response to the lawsuit, the members filed a counterclaim against the cooperative and several officers and members of the board of trustees. They asserted claims of breach of fiduciary duty, breach of contract, fraudulent concealment, and negligence. The counterclaim relied on allegations that:

- compensation received by officers and trustees is excessive and many multiples of that received by persons in similar positions in similar organizations
- compensation received by such persons is underreported by the cooperative and is fraudulently concealed
- the cooperative engaged in wasteful spending by paying excessive compensation and by allowing the board to incur excessive or unauthorized expenditures for travel, hotel rooms, dining, and training
- the cooperative has not reported, published, or given notice of the members' capital credit accounts and allocations
- the cooperative has failed to establish a retirement plan and carries "enormous" patronage capital on its books in violation of a New Mexico statute

With regard to the cooperative's petition, in mid-2011, the court ruled in favor of the members, stating, in effect, that despite the difficulty the bylaw changes may cause to the cooperative, the members' prerogative must control. The counterclaim remains pending.

NORTH CAROLINA

Lockerman v. South River Electric Membership Corporation

A class action lawsuit in North Carolina was filed on behalf of deceased members of South River Electric Membership Corporation. The complaint centers around the electric cooperative's practice of discounting capital credits of estates to present value, a common practice among many cooperatives. The plaintiffs allege that the discounting plan results in a



conversion (i.e., taking) of a portion of the estates' capital credits, and that the discount is improperly transferred into the cooperative's permanent equity.

The complaint seeks an order declaring that:

- certifies the class
- the cooperative's bylaws are unlawful
- the cooperative must discontinue the discounting program
- the cooperative should distribute the account values without applying a discount
- awards restitution, pre-judgment interest, punitive damages, attorney fees and costs

The complaint also asserts claims of breach of fiduciary duty, breach of contract, conversion, unjust enrichment, ultra vires, intra vires, and unfair or deceptive trade practices.

The complaint echoes arguments and allegations made in lawsuits filed in other states. It asserts that the deceased members are locked into perpetual investments without any expectation of return. The plaintiffs allege that the discounting program equates to an "involuntary contribution to [the EMC's] permanent equity." Similar to the Texas lawsuit against Denton County Electric Cooperative d/b/a CoServ Electric, the complaint against South River EMC specifically alleges that the practice of discounting capital credits to present value is improper.

In August 2012, the trial court ruled that the cooperative had no fiduciary duty to the plaintiffs. In addition, it declared that the cooperative had adequate authority to adopt a procedure for retiring deceased members' capital credits on an accelerated and discounted basis. However, it expressly did not rule on whether the cooperative, in practice, properly discounted the capital credits. In other words, the court reserved judgment on the specific manner of discounting the particular capital credits at issue in the case.

Read more about the trial court ruling on AHC's [Cooperative Law Blog's](http://www.ahclaw.com/cooperative/?cat=10) post entitled "Cooperative Litigation Update: N.C. Court Rules on Coop's Discounting Program," found here: <http://www.ahclaw.com/cooperative/?cat=10>.

The case remains open, but the court's order is viewed as substantively favorable to the cooperative.



SOUTH CAROLINA

Mansfield v. Edisto Electric Cooperative, Inc.

Former members of Edisto Electric Cooperative brought a class action suit in state court claiming that the cooperative improperly retained capital credits of former members pursuant to illegal bylaw provisions.

The plaintiffs allege, among other things, that:

- Edisto’s bylaws restrict the cooperative from refunding capital credits until the death of members and do not provide for interest.
- Although Edisto has the ability to refund capital credits to its members and former members, the Board and management refuse to do so.
- Edisto’s bylaws discriminate against former members in favor of current members, lock former members into a perpetual investment in the cooperative without expectation of return, and deprive former members of any right to vote and have a voice in the control of the cooperative.
- Edisto’s bylaws are contrary to public policy, illegal, and unfairly prejudicial to former members.
- Edisto’s policies concerning capital credit retirement result in a forfeiture of former members’ capital credits that violates cooperative principles and South Carolina’s Rural Electric Cooperative Act.

The plaintiffs seek various forms of relief, including:

- cancellation of allegedly illegal bylaw provisions and corporate resolutions
- direction to the cooperative to refund patronage capital with interest

The plaintiffs’ claims include claims for declaratory relief, for an accounting, and for violation of the South Carolina Unfair Trade Practices Act.

In mid-2009, the cooperative removed the case to federal court by adding a third-party claim against the Rural Utilities Service (“RUS”). In response to the complaint, the cooperative asserted defenses based, among other things, on the following:

- the plaintiffs failed to name the RUS as a necessary party



- applicable federal law and regulations, along with RUS contractual agreements, control the matter and preempt state law relied upon by the plaintiffs
- members' rights do not vest until retirement
- bylaw provisions and the business judgment rule
- statutes of limitation

In its third-party claim against RUS, the cooperative argued that it should be equitably indemnified by RUS. In certain cases, regulations and covenants of the RUS limit the times when an RUS borrower may retire capital credits. The cooperative argued that it simply complied with these regulations and covenants, and that if such compliance resulted in liability, then RUS should be responsible. In other words, since the cooperative was forced to comply with RUS regulations and covenants, if the court finds it liable to the plaintiffs, then the RUS is liable to the cooperative.

The federal court did not buy into this argument, however, because RUS was protected by sovereign immunity. Though the cooperative argued that Congress waived such sovereign immunity, the court believed that statutory language granting RUS authority to issue loans did not express any Congressional intent to waive sovereign immunity. The cooperative filed a notice of appeal, but the parties and the Court of Appeals have agreed to suspend appellate proceedings pending settlement between the parties.

Since the basis for federal district court jurisdiction was eliminated by the dismissal of RUS, in March 2010, the federal court remanded the case back to state court, where it remains pending.

Mitchum v. Aiken Electric Cooperative, et al.

This lawsuit was brought by former members of six named South Carolina electric cooperatives as a class action as well as a “reverse” class action. A reverse class action is one in which plaintiffs name certain defendants as representatives of a putative class of defendants. In this case, the putative class of defendants includes all electric cooperatives in South Carolina (except Edisto Electric Cooperative, which was named in the lawsuit discussed above). The plaintiffs claim that, even if the court does not certify the class of defendants, all of the electric cooperatives should be made parties to the lawsuit since their interests would be affected by the court’s interpretation of their bylaws.

The plaintiffs seek to represent a putative class of former cooperative members. As with the Edisto case, the plaintiffs claim that the cooperatives improperly retained capital credits of former members pursuant to bylaw provisions that are illegal. Importantly, the plaintiffs cite a South Carolina statute that purportedly requires retirement of capital credits *on an annual basis*.



The plaintiffs also allege, among other things, that:

- Some of the cooperatives' bylaws restrict the cooperative from refunding capital credits until the death of members, while other cooperatives refund capital credits only after long periods of time and without interest.
- Although the cooperatives have the ability to refund capital credits to their members and former members, the cooperatives refuse to do so.
- The cooperatives' bylaws discriminate against former members in favor of current members, lock former members into a perpetual investment in the cooperative without expectation of return, and deprive former members of any right to vote and have a voice in the control of the cooperative.
- The cooperatives' bylaws are contrary to public policy, illegal, and unfairly prejudicial to former members.
- The cooperatives' policies concerning capital credit retirement result in a forfeiture of former members' capital credits that violates the cooperative principles and South Carolina's Rural Electric Cooperative Act.

The plaintiffs seek various forms of relief, including:

- cancellation of allegedly illegal bylaw provisions
- direction to the cooperatives to refund patronage capital with interest
- direction to pay out all unclaimed retired capital credits and pay for costs of locating former members
- treble damages and attorney fees

The plaintiffs seek declaratory relief and accounting, and assert claims for violation of the South Carolina Unfair Trade Practices Act and breach of fiduciary duty. Several of the defendant cooperatives have filed motions to transfer the case to courts with appropriate venue. Currently the case and these motions are pending.

Burgess v. Santee Electric Cooperative, Inc.

A group of current members filed suit against Santee Electric Cooperative, Inc. alleging various claims related to mismanagement and election irregularities. The lawsuit is a class action as well as a derivative lawsuit. The putative class includes all current members of the



cooperative. As a derivative lawsuit, the plaintiffs seek to enforce rights belonging to the cooperative which its board and management allegedly have failed to enforce.

The plaintiffs seek declaratory and injunctive relief and assert claims for negligence, breach of fiduciary duty, breach of contract, breach of contract accompanied by a fraudulent act, fraud, constructive fraud, civil conspiracy, conversion, and interference with a contractual relationship. In support of their claims, the plaintiffs allege:

- the board paid compensation to its members and former board members in violation of a South Carolina statute
- the board travels to “meetings” that are “thinly disguised vacations” at the expense of the cooperative
- the cooperative provides the board with perks and benefits, including equipment at no charge and installed “dummy” power lines used to attract dove for hunting
- adopting bylaws that require unattainable measures to prevent opposition to incumbent board members
- manipulating annual meetings to reduce member turnout
- “buying” seats on the board
- failing to maintain proper records and even shredding records after learning of a potential lawsuit
- threatening employees who become involved with an opposition group, and offering benefits to those employees that prevent the lawsuit
- failing to retire capital credits as required by the bylaws

The plaintiffs seek an order enjoining the board from further wrongdoing. In addition, they seek:

- removal of board members and certain members of management
- a special meeting of members to revise the bylaws for fair elections and more transparency, as well as a review of compensation and benefits for the board and management



- the appointment of a receiver to manage the cooperative during the interim period
- disgorgement of excessive compensation and benefits

Several motions have been filed, and the matter remains pending.

TEXAS

Denton County Electric Cooperative, Inc. d/b/a CoServ Electric (three cases)

Three groups of lawsuits concerning capital credits have been filed against electric cooperatives in Texas. One of the cooperatives, CoServ Electric, has been involved in three separate lawsuits, two of which directly relate to its practice of retiring capital credits at a discount, as opposed to face value.

In the first two lawsuits, the plaintiffs – who are technically plaintiffs-in-counterclaim due to the procedural posture of the case – contend that CoServ Electric improperly retained the discount (the difference between face value and discounted value) as permanent equity. In the third lawsuit, CoServ sought to enjoin one of its directors, Mark Glover, who is the alleged whistleblower in the other two lawsuits, from disseminating confidential member information.

The putative class includes current and former members of the cooperative who claim that the cooperative wrongfully converted \$54 million of patronage capital into permanent equity and failed to distribute such patronage capital to its current and former members. They further allege that:

- Between 2003 (when the cooperative emerged from bankruptcy) and 2008, the cooperative supposedly retired \$75 million in capital credits to its current and former members, but distributed only \$21 million in cash.
- Defendant failed to disclose that it converted the remaining \$54 million in capital credits into permanent equity that belongs to the cooperative, and justified such conversion as a “discounting” of capital credits.
- Discounting capital credits to obtain permanent equity without disclosure or member consent is illegal, a breach of contract, and is a violation of the fiduciary duties owed to the members.
- The cooperative wrongfully used the election process for board elections to favor incumbents or challengers.



- The incumbent board members maintain control of the board and rubber-stamp the actions of the management team.
- The cooperative's actions violate the cooperative principles, including the principle of democratic member control, in that the cooperative fails to maintain open records, open meetings, and fair board elections.
- Directors and management diversified the cooperative's business into for-profit ventures such as golf courses, hotels, and natural gas businesses that led the cooperative to file for bankruptcy protection and led CFC to describe the cooperative's management practices as "imprudent" and its management as acting in bad faith.

The plaintiffs seek various forms of relief, including:

- an order requiring the cooperative to retire capital credits on a reasonable and systematic basis
- an order requiring the cooperative to provide class members with an accounting of capital credit accounts
- interest, attorney fees, and punitive damages

The claims include alleged violations of the state unfair trade practices act, claims for declaratory and injunctive relief and claims of conversion, breach of fiduciary duty, breach of contract, and unjust enrichment.

The complaint and counterclaim reference various articles and treatises concerning cooperatives, RUS publications, NRECA and CFC reports concerning capital credits and various tax cases, NRECA's Capital Credits Task Force Report, news stories about the Cobb EMC lawsuits, written materials from other cooperatives concerning capital credits, treatises on cooperatives, and Congressman Jim Cooper's policy essay about the improper operations and practices of electric cooperatives.

The plaintiffs moved to certify the class of current and former members, but the trial court declined to certify the class. Subsequently, the court granted the plaintiffs' motion to certify a *class of current members*. The cooperative appealed this ruling arguing:

- The trial court based the class certification on a misunderstanding of Texas law of electric cooperatives. As part of the class certification, the trial court improperly applied (by analogy) certain provisions of Texas's non-profit corporation code, including provisions that grant members legal recourse for statutory violations.



- Members do not have standing to sue the cooperative for a violation of the electric cooperative enabling act, apart from any breach-of-contract action based on violation of the bylaws.

The court of appeals ruled in favor of the cooperative, concluding that electric cooperatives were sufficiently dissimilar to non-profit corporations such that the non-profit corporations code should not generally apply to electric cooperatives. Accordingly, the members do not have any substantive right for the cooperative's alleged violation of the enabling act. Instead, their remedy is through claims based on breach of the bylaws.

The appellate court also held that nothing in the electric cooperative enabling act created a fiduciary duty from the cooperative to its members. "We conclude that whether the cooperative itself owes a fiduciary duty to its members is another claim best suited for a legislative determination." In other words, if the Texas legislature wanted to allow members to sue their cooperative based on violations of purported statutory rights, it would have said so in the statute, or it could amend the statute.

More detailed information is available on AHC's [Cooperative Law Blog's](http://www.ahclaw.com/cooperative/?p=420) post entitled "Cooperative Litigation Update: Texas Cooperative Lawsuit Considered on Appeal, which is found here: <http://www.ahclaw.com/cooperative/?p=420>.

Based on these rulings, the appellate court vacated the trial court's class certification, and remanded the case back to the trial court to reconsider the plaintiffs' motion in light of its clarification. Clearly, the ruling gives the cooperative an upper hand in the case.

Canales v. Nueces Electric Cooperative

The second lawsuit involves claims by current members of Nueces Electric Cooperative against the cooperative and certain of its officers and directors. The plaintiffs' claims are based on the following allegations:

- The cooperative paid excessive compensation to its directors, which was many multiples of that paid to persons in similar positions at similar organizations. Such compensation resulted in a waste of assets and self-dealing transactions by the directors.
- Contractual arrangements granted a G&T cooperative an extremely favorable option to purchase the cooperative's assets, which purportedly violates bylaw provision governing asset sales.



- The cooperative created a division to sell electricity to non-members, resulting in an increase in cost of service to members.
- In violation of its bylaws, the cooperative does not have a capital credits retirement plan and does not provide notice of capital credits allocated.

Based on these allegations, the plaintiffs assert claims for breach of fiduciary duty, breach of contract, negligence, and gross negligence, and seek declaratory and injunctive relief, such as the removal of directors and officers, accounting and disgorgement, and the creation of a constructive trust. The case is currently pending.

Worrall v. Pedernales Electric Cooperative, Inc.

In the third Texas lawsuit, a proposed class of current and former members of the cooperative brought suit against the cooperative and its officers, directors and advisory directors. The plaintiffs claim that the defendants breached their fiduciary duties in the management and disposition of the plaintiffs' patronage capital and in the operation of the cooperative.

The plaintiffs allege that:

- The cooperative has failed to report or give notice to patrons of the amount or status of their capital accounts.
- Although the cooperative has over \$164 million in patronage capital, the cooperative has never retired a patron's capital account in whole or in part as required by the bylaws and state law, and has never returned any revenue to members.
- The cooperative violated the state cooperative statute which requires cooperatives to periodically return patronage capital to their members.
- Directors and advisory directors are receiving excessive compensation in violation of the cooperative's bylaws and the Internal Revenue Code.
- The cooperative has purchased a for-profit company contrary to the advice of its professional advisors and invested vast amounts of money in the company without reporting such investments to the members.

The plaintiffs seek various forms of relief, including:

- an order requiring the cooperative to provide an accounting of patrons' capital accounts



- removal of all officers, directors and advisory directors of the cooperative
- interest, actual damages and exemplary damages

The plaintiffs' claims include claims for declaratory relief and claims of negligence and gross negligence, breach of fiduciary duty, breach of contract, constructive fraud, and civil conspiracy.

This suit was settled in late 2008. Under the terms of the settlement agreement:

- The cooperative was required to retire \$23 million in capital credits to its members over a 5-year period, in addition to \$7 million retired in 2007.
- The cooperative agreed to pay the attorneys' fees and expenses of the plaintiffs and their attorneys, not to exceed \$4 million.
- Directors and the General Manager agreed to resign and forfeit approximately \$600,000 in deferred compensation.
- The cooperative agreed to be subject to an investigation of its finances and management by an independent consulting firm, with the investigation to cover a ten-year period and to be overseen by the state public utility commission.
- Upon the settlement, State Senator Troy Fraser made a statement to the press that, "I think it's a sad day in the Texas Hill Country when it takes a lawsuit, a couple of state legislators, and a federal judge for people to get back what's rightfully theirs."

CONCLUSION

Electric cooperatives should use the onslaught of lawsuits as an impetus to review their current operations, policies, and practices. Though many of the allegations against cooperatives are exaggerated or patently wrong, some of them may demonstrate areas in which some cooperatives should improve. Even the best, well-run cooperative has room for improvement.

To prepare for claims, cooperatives can take a number of proactive measures. One of the first steps we recommend is an effective capital credits retirement policy. While the effectiveness of such a policy depends on whether and how the board follows the policy, the existence of a policy is a big first step.

Another important step is addressing member concerns in an open and transparent manner. Underlying most of the lawsuits is a group of disgruntled members who believe that



neither management nor the board has listened to or properly addressed their concerns. They feel disenfranchised when they have no outlet to express their concerns, and no acknowledgement that the concerns have even been heard. Some of the lawsuits might have been avoided by small steps to foster member relations, or creating an environment of openness and transparency.

More proactive cooperatives will engage legal counsel for a “legal audit” to (i) assess the risks of lawsuits and (ii) recommend a range of actions to mitigate such risk. Legal counsel may approach the legal audit using a team approach, which might include input from management, directors or trustees, and even some influential members. In the end, cooperatives should take appropriate steps in light of their perceived risk.

MORE INFORMATION

An article written by AHC attorney David R. Cook, entitled “[Effectively Managing Capital Credits](#),” is available online on AHC’s [Resources Page](#). The article provides additional information for management, including cooperative accountants, and ways to mitigate the risk arising from capital credit management.

The attorneys at Autry, Horton & Cole, LLP are dedicated to keeping cooperatives informed with the latest on cooperative law. They regularly post to a Cooperative Law Blog at www.ahclaw.com/cooperative. Subscribers can visit the blog to submit an email address for email updates or set up RSS updates.

Additionally, our attorneys have written extensively on many topics of cooperative law, including

- cooperative taxation
- cooperative governance, including transparency issues
- contested elections
- smart meters

These writings and publications are available online at AHC’s [Resources Page](#).

Finally, David R. Cook periodically releases AHC Cooperative Taxation Briefs to provide information on the latest rulings and changes to cooperative taxation. The briefs are available on AHC’s [Resources Page](#) and AHC’s [Cooperative Law Blog](#).