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## Patronage Capital Lawsuits Against Electric Cooperatives on the Rise

In 2009-2010, at least six class action lawsuits have been filed against electric cooperatives over patronage capital (or capital credits). Most are in active litigation. Depending upon the lawsuit, the plaintiffs allege that the cooperative breached its obligations to members and violated state law by:

- Failing to retire capital credits altogether;
- Involuntarily discounting capital credits;
- Retiring capital credits only upon the death of a member; and
- Preferring current members over former members in retiring capital credits.

Some of the complaints also include allegations regarding:

- Mismanagement of the cooperative's affairs;
- Unauthorized activities funded with members' capital;
- Overcompensation of officers and directors;
- Violation of cooperative principles by withholding information from members and rigging director elections.

These class action suits seem to be part of a coordinated effort. In some of the suits, the plaintiff members are represented by common law firms based in New York and Texas. Below is a brief summary of these cases.

### *Capps v. Carroll Electric Cooperative Corporation (Arkansas) (2009-1773-02)*

On June 10, 2009, a member of Carroll Electric Cooperative Corporation filed a class action complaint against the cooperative in an Arkansas state court, alleging that "Carroll Electric has refused and continues to refuse to refund capital ('patronage capital') that rightfully belongs to class members." (Carroll Compl. ¶ 1.) At issue is more than \$170 million of patronage capital.

In its answer, Carroll Electric relied principally on the business judgment rule. Carroll Electric also pointed out that, as the Arkansas Code seemingly contemplates, its patrons benefit from patronage capital in the form of significantly lower rates. It also defended its high equity ratio of 57.5%, explaining that such ratio is prudent given Carroll Electric's business environment.

On November 20, 2009, the plaintiffs filed an amended complaint, which Carroll denied. On April 14, 2010, the Circuit Court in Benton County, Arkansas, dismissed all claims relating to a monetary refund of patronage capital, holding that the exclusive jurisdiction to adjudicate such rights rested with the Arkansas Public Service Commission. On April 30, at the request of the plaintiffs, the court dismissed the plaintiffs' remaining equitable (nonmonetary) claims. These equitable claims sought to change the cooperative's election procedures, distribution of funds, and other functions. On May 14, the plaintiffs filed a notice of appeal.

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## The CoServ Lawsuits

*Denton County Electric Cooperative, Inc. d/b/a CoServ Electric v. Glover* (Texas) (2009-10087-16) (“Glover” case)

*In re Denton County Electric Cooperative, Inc. d/b/a CoServ Electric* (Texas) (2009-30003-211) (“Brady” case)

*In re Denton County Electric Cooperative, Inc. d/b/a CoServ Electric* (Texas) (2009-30075-211) (“Confer” case)

In the spring of 2009, three class action petitions were filed in a Texas state court against Denton County Electric Cooperative (CoServ) based on CoServ’s alleged practice of “discounting” class members’ capital credits, as well as allegations of mismanagement and rigging of director elections.

The essential claim in all three petitions is that CoServ supposedly retired \$75 million in patronage capital to its members and former members, but in actuality distributed only \$21 million in cash, converting the remaining \$54 million into “permanent” equity that belongs to CoServ.

In the Glover case, the trial court granted certification of the “voting class” but denied certification of the “equity class” — which was the proposed class that sought changes in the retirement of CoServ’s patronage capital. The Glover district court denied certification to the equity class based, among other things, on conflicts within the class, which included both current and former members. The trial court’s ruling on the equity class certification has not been appealed, although issues relating to the voting class are currently on appeal in the Texas Court of Appeals.

CoServ has filed a motion to consolidate the Brady and Confer cases with the Glover case. Litigation remains ongoing.

### *Mansfield v. Edisto Electric Cooperative, Inc. (South Carolina) (09-cv-01645)*

On May 21, 2009, the plaintiffs (former coop members) filed this class action suit against Edisto Electric Cooperative in the state court of South Carolina, based on Edisto’s practice of returning patronage capital only upon the death of members. This case was later removed to federal court.

The plaintiffs allege that, according to Edisto’s bylaws, patronage capital is not payable to the plaintiffs until their death and then is payable at the pleasure of Edisto without interest. The plaintiffs further allege that Edisto has the ability to refund patronage capital to current and former members, and is required by law to do so.

In response, Edisto relied on the business judgment rule, applicable statutes of limitation, federal preemption and other defenses. Its federal preemption defense is based on 7 C.F.R. § 1717.617, which provides that if a Rural Utilities Service (RUS) borrower is required by its loan documents to obtain RUS approval before retiring any patronage capital, approval is given if, after the distribution, the borrower’s equity will be 30% or more of its total assets. Edisto also asserted a third-party counterclaim against RUS, claiming that RUS should indemnify Edisto for any amounts it has to pay the plaintiffs. RUS moved for dismissal on the ground of sovereign immunity.

On March 30, 2010, the federal district court in South Carolina granted RUS's motion to dismiss the third-party complaint on the ground of sovereign immunity. The court also granted the plaintiffs' motion to remand the case to state court.

### *Burks v. White River Valley Electric Cooperative (Missouri) (09DG-CV00140)*

On July 12, 2010, two former members of the White River Valley Electric Cooperative filed a class action suit based on White River's failure to refund capital credits. The plaintiffs allege that White River has not refunded any capital credits in more than two decades. The proposed class consists of all former members of the electric cooperative. The plaintiffs contend that White River possesses "millions of dollars" in capital credits.

This is the second complaint filed by these same plaintiffs. The first case was filed in 2009 and proposed a class of both former members and current members who had been members 20 years or more and whose capital credits had not been returned. The plaintiffs voluntarily dismissed the first case after White River filed a motion to dismiss. Among other arguments, White River pointed out that a conflict of interest existed between the current and former members of the proposed class, because returning capital credits as demanded by the plaintiffs would force current members to pay more for electric service. As noted above, the new complaint proposes a class of only former members.

The new complaint also includes a new defendant – Associated Electric Cooperative, Inc. (AECI). Under a three-tier system, AECI supplies power to six regional generation and transmission cooperatives (G&Ts), that in turn provide power to distribution cooperatives, including White River. The plaintiffs allege a conspiracy among White River, two of the G&Ts (Kamo Power Cooperative and Sho-Me Electric Cooperative), and AECI to withhold payments of capital credits. The plaintiffs assert that these cooperatives maintain high equity-to-asset ratios and high patronage capital balances. (The G&Ts are not named as defendants.)

The defendants' responsive pleadings are expected to be filed soon.

### *Shea v. Cobb Electric Membership Corporation (Georgia) (10100353-48)*

On January 15, 2010, two former members of Cobb EMC and the estate of a deceased member filed a class action complaint against the cooperative. The proposed class seeks the return of approximately \$150 million in capital credits. The complaint alleges that Cobb EMC has not returned capital credits since 1976. This class consists solely of former members who claim that current members are unjustly enriched at their expense. They contend that if need be, Cobb EMC should raise the rates charged to current members in order to have sufficient funds to return capital credits to former members.

Cobb EMC moved to dismiss the complaint on various grounds, including the discretion vested in the cooperative to manage its own affairs. The plaintiffs have also requested that the assigned judge recuse himself, since he is a member of Cobb EMC. Litigation remains ongoing.

### *Mitchum et al. v. Aiken Electric Cooperative et al. (South Carolina) (2010-CP-02-00206)*

Recent patronage capital lawsuits have targeted just one or two electric cooperatives. But the complaint in *Mitchum et al. v. Aiken Electric Cooperative et al.*, which was served on the defendant cooperatives in June 2010, significantly expands the potential pool of defendants. In this case, the plaintiffs have named as defendants *all* South Carolina electric cooperatives (other than Edisto, which is the subject of another patronage capital suit).

The plaintiff class consists of former customers of South Carolina electric cooperatives whose patronage capital has not yet been refunded. Citing S.C. Code Ann. § 33-49-460, the purported class argues that “cooperative principles to which all South Carolina cooperatives claim to adhere require them to operate at cost [and] to refund revenue above costs to the owner/customer as an overcharge or ‘patronage’.” (Compl. ¶¶ 13, 27.) These former customers also complain that the cooperatives favor the interests of current customers, exclude former customers from participating in cooperative governance, and make no attempt to locate former customers, thereby allowing a forfeiture of those customers’ capital credits.

The allegations are made against all South Carolina electric cooperatives (other than Edisto), which the plaintiff class argues are necessary parties “since all have interests which would be affected by a South Carolina court’s interpretation of the lawfulness and propriety of their bylaws and business dealings with respect to the rights and pecuniary interests of members who are former customers.” (*Id.* ¶ 9.) The case was filed in Aiken County, South Carolina. Litigation remains ongoing.

## Conclusion

Electric cooperatives vary widely in their policies governing the retirement of capital credits. Some cooperatives retire capital credits on a regular basis, and some do not. Some cooperatives retire capital credits only for deceased patrons. Several cases reference the National Rural Electric Cooperative Association’s recommendations regarding capital credits. In addition, the *Mitchum* suit significantly expands the potential pool of defendants. The increase in litigation over the capital credits issue shows, at a minimum, that cooperatives should ensure that their capital credit policies are in keeping with all legal requirements.

Sutherland will be hosting a webinar on these cases and other issues relating to patronage capital. Information regarding this webinar, including date and time, will be sent soon.



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