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## Litigation Update on 14 Patronage Capital Cases in Eight States

Since 2009, at least 14 cases have been filed against electric cooperatives over patronage capital (or capital credits) in eight states: Alabama, Arkansas, Georgia, Missouri, New Mexico, North Carolina, South Carolina, and Texas. Sutherland has previously issued Legal Alerts regarding these cases—most are in active litigation, some have apparently settled (or are close to settling), and others have been resolved in the cooperative's favor.

Depending upon the lawsuit, the plaintiffs allege that the cooperatives breached their obligations to members (and/or former 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
- Preferring current members over former members when 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

This Legal Alert provides a status update, by state, on the 14 patronage capital cases filed since 2009.

### ALABAMA

***Recherche LLC v. Baldwin County Electric Membership Corp. (CV-2012-900820, Baldwin County); Harkless v. Dixie Electric Cooperative (CV-2012-900073, Macon County)***

#### Status: Pending

In June 2012, two cases were filed in Alabama against two different electric cooperatives: *Recherche LLC v. Baldwin County Electric Membership Corp.* (CV-2012-900820, Baldwin County, AL) and *Harkless v. Dixie Electric Cooperative* (CV-2012-900073, Macon County, AL). The two cases were filed on the same day, June 27, 2012, and have the same plaintiffs' attorneys.

The *Baldwin EMC* and *Dixie* complaints are nearly identical, and they share many similarities with the other patronage capital cases that have been filed so far. In essence, the plaintiffs claim that the coops did not comply with their statutory obligations to refund patronage capital to their members, and that many members move away or die before the patronage capital is refunded—thereby allowing the coops to unlawfully retain the funds. The plaintiffs further claim that the coops are required under Alabama law to

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refund patronage capital on an annual basis. Both cases are class actions, brought on behalf of all present and former members of the coops.

The *Baldwin EMC* and *Dixie* Defendants have both filed similar motions to dismiss on four grounds: First, the plaintiffs have failed to allege that the Defendants breached their bylaws. Second, the plaintiffs do not have a private right of action under the enabling statute for cooperatives. Third, the plaintiffs have no right to annual disbursements of revenues. Fourth, the plaintiffs' claims are barred by the statute of limitations and the rule of repose. In a one-page order, the court denied Baldwin EMC's motion to dismiss. The court has not yet ruled on Dixie's motion.

We note that at least one court has ruled that present and former members cannot be part of the same class. In *Denton County Electric Cooperative, Inc. d/b/a CoServ Electric v. Glover*, (Texas) (2009-10087-16), 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 on, among other things, conflicts within the class, which included both current and former members. The trial court's ruling on the equity subclass certification was not appealed.

## ARKANSAS

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

#### Status: Dismissed

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." At issue is more than \$170 million in patronage capital.

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 February 9, 2011, the Supreme Court of Arkansas—concluding that capital credits were "public" rather than "private" rights and that the Arkansas Public Service Commission had exclusive jurisdiction to adjudicate those rights—affirmed the decision of the appellate court.

## GEORGIA

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

#### Status: Pending

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 in a Cobb County, Georgia, superior court. 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 original complaint, as well as a later amended complaint, on various grounds, including the discretion vested in the cooperative to manage its own affairs. The plaintiffs are seeking class certification, though the court has not yet ruled on the motion.

In June 2013, the trial court granted a motion to intervene filed by current members of Cobb EMC. On July 18, 2013, the intervenors, who have separate counsel from the former members, filed their complaint, which also seeks class action certification. Litigation remains ongoing.

## MISSOURI

### *Burks v. White River Valley Electric Cooperative (1031-CV10307)*

#### **Status: Dismissed/Unknown**

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 second complaint proposes a class of only former members.

The second complaint also added 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 Electric Cooperative and Sho-Me Power 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.)

AECI and White River have both filed motions to dismiss and motions to transfer venue. Among other defenses, the defendants claim that AECI does not belong in the case, because it does not dictate the manner, method, or timing of the payment of capital credits, and that the plaintiffs' claims are barred by the business judgment rule.

On March 29, 2011, the case was dismissed without prejudice, at the plaintiffs' request. Nothing new has been filed on the docket since then.

## NEW MEXICO

### *Socorro Electric Cooperative v. West et al. (D-1314-CV-0201000849)*

#### Status: Pending

On June 29, 2010, Socorro Electric Cooperative filed a claim for declaratory relief against its members, alleging that it was not a public entity and therefore not subject to the requirements of the New Mexico Open Meetings Act and the New Mexico Inspection of Public Records Act.

On August 23, 2010, member Charles Wagner filed a cross claim and class action certification request, alleging that Socorro's treatment of patronage capital was unlawful. The member also raised corporate governance claims, including wasteful spending and excessive compensation. The plaintiff class consists of current members of Socorro. At issue is more than \$16 million in patronage capital.

Socorro later filed a voluntary dismissal against all defendants/members who had not filed an answer or responsive pleading. Socorro has further denied the allegations in its member's complaint and has raised various defenses including the business judgment rule. Litigation remains ongoing.

## NORTH CAROLINA

### *Lockerman v. South River Electric Membership Corp. (11-CVS-152) (formerly Jackson v. South River Electric Membership Corp.)*

#### Status: Pending

On August 8, 2012, the North Carolina Business Court held that electric cooperatives may lawfully discount capital credits of deceased members when they are retired early. The court also held that electric cooperatives do not owe a fiduciary duty to those members with respect to the timing and procedures for retiring capital credits. The court did not address whether the individual applications of certain estates were handled correctly.

These rulings were made in *Lockerman v. South River Electric Membership Corp.* (11-CVS-152, Sampson County, North Carolina), a class action case filed in February 2011. In the complaint, the plaintiffs challenged South River Electric Membership Corporation's (SREMC) decision to amend its bylaws in 2001 to allow for discounting the early retirement of capital credits upon the death of a member. Under this procedure, the estate of a deceased member is allowed to request that accrued capital credits be paid out without waiting for the scheduled retirement date. If the request is granted, SREMC reduces the amount of the capital credit to reflect the time value of money. Plaintiffs alleged that this was done in order to benefit SREMC by converting to permanent equity the difference between an estate's total capital credits and the amount refunded after discounting.

The court found that SREMC's discretionary determination to adopt the early retirement discounting policy was a lawful exercise of the directors' business judgment. The court noted that legislatures and courts in other jurisdictions had recognized the purposes achieved by discounting early retirements. The court also ruled that SREMC did not owe a fiduciary duty to the plaintiffs' estates with respect to the

retirement of their decedents' capital credits. The court further observed that the form signed by estate representatives to request early retirement disclosed on its face that a discount factor would be applied in determining the amount of capital credit to be refunded.

The plaintiffs appealed the court's summary judgment rulings regarding the breach of fiduciary duty claims to the North Carolina Court of Appeals. On August 6, 2013, the Court of Appeals dismissed the appeal as interlocutory. The plaintiffs' other claims for declaratory judgment, conversion, unjust enrichment, unfair or deceptive practices, and breach of contract remain pending before the district court.

## SOUTH CAROLINA

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

#### Status: Settlement Pending

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 limitations, 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, finding in part that the federal regulations cited by Edisto did not expressly preempt the state court action because the action dealt with internal corporate governance. The case was ordered remanded to the South Carolina Court of Common Pleas.

Edisto appealed these rulings to the U.S. Court of Appeals for the Fourth Circuit. Edisto later dismissed its appeal involving the RUS third-party claims.

According to status reports filed with the Court of Appeals, on January 28, 2013, Edisto tentatively agreed to settlement terms under a Memorandum of Understanding (MOU). The MOU contemplates changes to Edisto's corporate accounting. The parties are waiting on a private letter ruling from the Internal Revenue Service before finalizing the settlement, the precise terms of which are unknown.

### ***Mitchum v. Aiken Electric Cooperative (2010-CP-02-00206)***

#### **Status: Settlement Pending**

In this case, 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 costs [and] to refund revenue above costs to the owner/customer as an overcharge or ‘patronage.’” 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.” South Carolina cooperatives have not yet filed any responsive pleadings. The case was filed in Aiken County, South Carolina.

The resolution of this case is tied to the settlement negotiations and the IRS private letter ruling in the *Mansfield* case discussed above.

### ***Burgess v. Santee Electric Cooperative (2010-CP-45-00278)***

#### **Status: Pending**

On August 6, 2010, three members filed a class action complaint against Santee Electric Cooperative. The complaint raises a host of corporate governance, compensation, election, and transparency claims. In addition, the complaint alleges that Santee Electric failed to adhere to the requirements regarding the allocation and retirement of patronage capital. On November 22, 2010, Santee Electric filed its answer, which included a range of defenses from the business judgment rule to the failure to exhaust administrative remedies. Litigation remains ongoing.

## TEXAS

### The CoServ Lawsuits:

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

Status: Pending

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

Status: Pending

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

Status: Dismissed Per Agreement

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 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.

The *Brady* and *Confer* cases were initially removed by CoServ to federal court, but were recently remanded back to state court. Litigation remains ongoing. 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 trial court's ruling on the equity subclass certification has not been appealed, although issues relating to the voting class are currently on appeal in the Texas Court of Appeals (Second Judicial District). On May 24, 2013, the parties agreed to dismiss the case with prejudice.

*Canales v. Nueces Electric Cooperative (2010DCV-5008-E)*

Status: Pending

On March 30, 2010, two members of the Nueces Electric Cooperative (NEC) filed a class action complaint alleging that, unlike most other cooperatives in Texas, NEC does not regularly return patronage capital to its members. The plaintiff class is defined as all current members of NEC. The plaintiffs also raised corporate governance and transparency claims. According to the complaint, NEC has more than 18,000 retail customers. At issue is more than \$38 million in patronage capital.



The district court in Duval County later transferred the case to the district court of Nueces County, Texas. The court has not issued any rulings on the merits. Litigation remains ongoing.



In 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. The increase in litigation over the capital credits issue shows, at a minimum, that cooperatives should ensure that their capital credits policies are in keeping with all legal requirements. These lawsuits also suggest that cooperatives may want to re-examine their capital credits policies.



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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