

DEMOCRACY AND DYSFUNCTION: RURAL ELECTRIC COOPERATIVES AND THE SURPRISING PERSISTENCE OF THE SEPARATION OF OWNERSHIP AND CONTROL

Debra C. Jeter, Randall S. Thomas, & Harwell Wells

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*Debra C. Jeter, Randall S. Thomas, & Harwell Wells**

Since the 1930s, corporate law scholarship has focused narrowly on the public corporation and the problem of the separation of ownership and control—a problem many now believe has been mitigated or even solved. With rare exceptions, scholars have paid far less heed to other business forms that still play important roles in the American economy. In this Article, we examine a significant and almost completely overlooked business form, the Rural Electric Cooperative (REC). RECs were founded in a moment of optimism during the New Deal. As with other cooperatives, their organizational rules differed sharply from those of for-profit corporations. They were owned by their customers, with each customer-member having one vote irrespective of their energy consumption, and it was hoped these owners would provide active oversight of the REC's managers and activities. Reality has proven otherwise. Corporate governance innovations of the last forty years have passed RECs by, leaving an organizational sector mired in governance dysfunctions stemming from the separation of ownership and control. Here we explain why RECs evolved as they did and why New Deal planners seized on the cooperative form to electrify the countryside; how significant governance problems have persisted, largely unaddressed, from the 1930s to today; and how a change in corporate governance rules, allowing for a market for corporate control in RECs, could fix some persistent problems in this still-important sector. Alternatively, we propose that RECs take up a new public role as rural broadband internet providers with a reinvigorated federal regulator to police governance failures.

INTRODUCTION

Since the 1930s, corporate law scholarship has tightly focused on the separation of ownership and control in the public corporation, a split often identified as the central problem for corporate law.¹ Academics have writ-

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1. The classic reference is ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933).

ten hundreds of articles decrying this split and proffered ways to close the gap between shareholders' interests and those of managers.² Over the decades corporate governance tools such as independent directors, empowered monitoring shareholders, activist investors, and stronger federal regulation, have been rolled forward to fix this separation.³ These changes have transformed American corporations, producing a rigorous monitoring environment and so altering the governance landscape that some critics now insist that corporate management needs greater separation from shareholders in order to have more discretion in how they run companies.⁴

Even as it focused on public corporations, however, corporate law too often overlooked other business organizations playing vital roles in the modern economy.⁵ In this Article, we focus on one such organizational form, the consumer cooperative, and specifically the problem of separation of ownership and control at Rural Electric Cooperatives (RECs). Created around the same time that Adolf Berle and Gardiner Means published their classic critique of modern corporations and the separation of ownership and control, *THE MODERN CORPORATION AND PRIVATE PROPERTY*,⁶ rural electric cooperatives worked deep social change by bringing electricity to millions of Americans in the depth of the Great Depression. Today they still operate over 40% of the nation's electrical lines and provide electric power to millions.⁷ Yet, we argue here, RECs remain hobbled by the governance problems that have been largely resolved in public corporations. It is time both to remedy this academic neglect of an important organizational form and to improve this corner of the American economy.

RECs sprang out of Franklin Roosevelt's New Deal. Then—as now—politicians sought ways to help rural Americans left behind by far-reaching economic changes.⁸ Then the changes were spurred by electrification,

2. The most widely cited article is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

3. For an excellent overview of the literature concerning these different corporate governance tools, see ROBERTA ROMANO, *FOUNDATIONS OF CORPORATE LAW* (2d ed. 2010).

4. See, e.g., Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1749–51 (2006).

5. For example, both the business trust and the limited liability company are competitors of the corporation that receive relatively little attention. See, e.g., LARRY E. RIBSTEIN, *THE RISE OF THE UNCORPORATION* (2010); Robert H. Sitkoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. ILL. L. REV. 31.

6. BERLE & MEANS, *supra* note 1.

7. Nat'l Rural Elec. Coop. Ass'n, *America's Electric Cooperatives: 2017 Fact Sheet*, AM.'S ELECTRIC COOPERATIVES (Jan. 31, 2017), <https://www.electric.coop/electric-cooperative-fact-sheet/>. See *infra* Part IV for a discussion of how RECs have recently returned to the spotlight now as potential providers of rural broadband internet services.

8. Jennifer Levitz & Valerie Bauerlein, *Moving at the Speed of Dial Up—Across Much of Rural America, Slow and Costly Broadband Bars Access to the New Economy*, WALL ST. J., June 16, 2017, at A1 (explaining that across much of rural America, broadband internet lags behind urban areas in speed and availability).

which had transformed cities but bypassed the countryside.⁹ In the early 1930s, while 90% of urban areas had reliable electric access, only 10% of rural communities were wired for power.¹⁰ To bring these communities into the twentieth century, in 1936 President Roosevelt pushed through the Rural Electrification Act, which led to the creation of RECs across the country.¹¹ The cooperatives' success was astonishing: within three years, 417 RECs had been established and served approximately 288,000 member-households, and eventually most of America's farmers had access to electric power thanks to RECs.¹²

These early RECs were a thing unto themselves, business organizations that differed notably from traditional for-profit businesses, intended not only to extend electrical lines but also to transform the culture of rural America. Their structure, which presumed active involvement by member-customers, was designed to educate farmers in democratic practices. These cooperatives were owned by their member-customers, and each member, no matter how large or how small their consumption of power, received a single vote to cast on cooperative affairs. Like shareholders, cooperative members were residual claimants of the cooperative's assets, entitled to receive credits for the capital that they paid into the business and refunds of any excess retained earnings that accumulated during its operation. The architects of the rural electric cooperative movement hoped that members would play active roles in their management too, exercising democratic control over a vital, locally rooted institution.

This is not how it turned out. From the beginning, RECs suffered from serious, recurring corporate governance problems that caused them to fall short of their founders' hopes. Too often they operated less as little republics than as small fiefdoms under the thumb of self-perpetuating, virtually self-appointed boards of directors.¹³ Officers would hire relatives, directors would engage in self-dealing transactions, and management would engage the cooperative in side businesses, all in violation of REC bylaws and the various state-law versions of the model Rural Electric Cooperative Act. Boards of directors did little to prevent the misconduct, and the very framework of cooperative management deterred member oversight or involvement. Cooperative members had almost no economic incentives to

9. Cecilia Kang, *How to Give Rural America Broadband? Look to the Early 1900s*, N.Y. TIMES (Aug. 7, 2016), <https://www.nytimes.com/2016/08/08/technology/how-to-give-rural-america-broadband-look-to-the-early-1900s.html>.

10. *Id.*

11. *Research on the Economic Impact of Cooperatives: Rural Electric*, U. WIS. CTR. FOR COOPERATIVES (May 5, 2010), <http://reic.uwcc.wisc.edu/electric/>.

12. *Id.*

13. See Jim Cooper, *Electric Co-operatives: From New Deal to Bad Deal?*, 45 HARV. J. ON LEGIS. 335, 340–42 (2008).

engage in careful monitoring of cooperative management, and the fact that each member had only one vote, irrespective of the amount of electricity they consumed, made it impossible to create large active blockholders to supervise management. Proxy voting was not generally permitted, so members who did not attend the annual meeting were effectively disenfranchised.

Almost from the inception of widespread rural electrification, the Rural Electrification Administration (REA), the RECs' regulator,¹⁴ recognized these problems and attempted—sometimes successfully—to address them. But many of the REA's goals went unmet because of the lack of individual member engagement in the cooperatives' management. In the well-known words of Berle and Means, at RECs there was a complete “separation of ownership and control” because the management bodies of many cooperatives were totally in control with no effective monitoring of their conduct.¹⁵

Today, RECs are still going strong: the nation's 897 electric cooperatives¹⁶ deliver approximately 11% of the nation's electricity, own 42% of the nation's electrical lines,¹⁷ and the median electric cooperative serves 12,000 customers.¹⁸ These cooperatives have already fulfilled their mission of bringing electricity, and in some cases telephone services, to rural areas. However, the internal corporate governance problems that were observed long ago persist. Decades after the governance problems of the modern corporation were identified and addressed, they flourish in RECs.

What should policymakers do about this? In this Article, we suggest that the best approach to resolving these problems is to open up the market for corporate control of RECs to permit market forces to provide the monitoring needed to improve their performance. Alternatively, we suggest that RECs should take on a new mission that will justify their continued existence, with a reinvigorated regulator—a “new REA”—to act as a government overseer substituting for the lack of market discipline. If the first approach is adopted, a market for corporate control will compel cooperatives to demonstrate that they can be as efficient as other utility service providers in meeting the needs of their customers, or else more efficient producers will acquire them. If the second option is pursued, we suggest that cooperatives make it their new mission to provide broadband internet services to currently underserved areas using low-cost government financing but with close supervision by government regulators to replace the largely nonexistent monitoring by members and the market. Recent federal

14. In 1994, the REA was renamed the Rural Utilities Service. *Research on the Economic Impact of Cooperatives: Rural Electric*, *supra* note 11.

15. BERLE & MEANS, *supra* note 1, at 4.

16. Nat'l Rural Elec. Coop. Ass'n, *supra* note 7.

17. *Id.*

18. Cooper, *supra* note 13, at 336.

proposals to push rural broadband expansion could be implemented using existing RECs.¹⁹ While we are agnostic about which proposal should be adopted, we recognize that both of them have benefits and costs that will affect their political viability.

This Article proceeds as follows. In Part I, we begin by asking why cooperatives are an important form of business organization. Drawing on the path-breaking work of Professor Henry Hansmann, we see that cooperatives are frequently an efficient, transaction-cost- and ownership-cost-minimizing form of organization. We apply Hansmann's theory to show that RECs can help consumers avoid the costs of large monopolistic electricity providers while also reducing the costs of rate regulation. However, we extend Hansmann's analysis by explaining that corporate governance malfunctions may appear in this form of organization when managers are not effectively monitored by the consumer-owners of the business.

Part II seeks to explain why cooperatives became the vehicle for rural electrification. We begin with the massive challenges facing advocates of rural electrification in the 1920s. While electrification was seen as vital for rural developments, as late as the 1930s, roughly 90% of Americans living in small towns or on farms had no access to electric power and no prospects of receiving it any time soon. Roosevelt's election in 1932 set the stage for government action: beginning with the passage of the Tennessee Valley Authority Act²⁰ (the Act) and the creation of the Tennessee Valley Authority (TVA), the federal government pushed for the creation of RECs, not because RECs were necessarily the most efficient way to provide power, but because private utilities were unwilling to take on the task. Thus, government planners chose cooperatives. When the REA was founded in 1935, it embarked on a massive program of creating electric power cooperatives across the nation and providing them low-cost loans. During the 1930s, approximately 90% of all REA loans went to cooperatives.

By the early 1940s, the REA had helped organize hundreds of RECs and loaned them hundreds of millions of dollars to build the electrical transmission lines needed to reach into the countryside. The governance of these cooperatives was of particular concern to the REA. Successful governance of cooperatives required not only an informed and involved board of directors but also an active membership. Unfortunately, despite the strenuous efforts of REA personnel, member-owners failed to monitor management, leading to repeated problems with self-dealing transactions by officers and directors and other abuses like self-perpetuation by boards

19. President Trump's recent executive order to accelerate rural broadband's expansion has attracted Congressional support. Michael Collins, *Congress to Push Broadband Expansion*, TENNESSEAN, Jan. 14, 2018, at A3.

20. PRESTON J. HUBBARD, ORIGINS OF THE TVA: THE MUSCLE SHOALS CONTROVERSY, 1920-1932, at 312-15 (1961).

of directors. Although the REA exhorted owner-members to get involved, they had little economic incentive to do so. These problems were never resolved, and today there continues to be no active monitoring force to police cooperative management and director actions.

For that reason, we advocate new policy options that would fill the monitoring gap. Part III develops our first policy option, the creation of an effective market for corporate control of RECs. We begin in Subpart A by discussing the separation of ownership and control that still exists at RECs: weak member oversight of powerful and self-interested boards of directors. We show how none of the traditional corporate law checks on managerial power work at RECs, leaving managers with great freedom to act in their own self-interest. We show that, at least for RECs in some states, such as Tennessee, REC management bodies do not distribute any dividends to their owners. This failure has led many investors to file lawsuits challenging REC boards' decisions not to make this type of distribution.

We propose that a dynamic market for corporate control would be able to discipline cooperative management and realign their incentives with those of their members. In Subpart B, we back up our policy diagnosis by showing that, using accounting measurements, a number of RECs would prove attractive takeover targets if current legal rules did not prevent such attempts. In Subparts C and D, we provide a case study of cooperative law in Tennessee, a locus for early development of RECs and where they still maintain a powerful presence. After discussing one distinctive element of electric cooperative government in that state, the role of TVA, we show how the legal rules in one jurisdiction raise high (and potentially insuperable) barriers to takeovers. We walk through the principal alternative methods by which a mergers and acquisitions (M&A) transaction of a Tennessee REC could be attempted—a sale of assets, a tender offer, a merger, or a proxy contest for corporate control—and show that none of them are viable under present law without the consent of the targeted cooperative's management. For example, Tennessee law on REC mergers does not permit mergers between RECs and investor-owned utility companies.

Finally, in Subpart E, we focus even more closely on one Tennessee rural electric cooperative, Middle Tennessee Electric Membership Corporation (MTEMC), for which there is public information about its bylaws. We show that it would be extremely difficult for even the most determined acquirer to gain control of this firm unless the REC's management endorsed the proposal and solicited member approval. We conclude that substantial changes need to be made to the laws governing RECs if policymakers wish to open the market for corporate control and create stronger incentives for efficient management of these firms. Taking a conservative approach, we propose that RECs should be made subject to the same corporate and secu-

rities laws that apply to any corporation, a step we believe could open the M&A market for cooperatives.

Part IV explores our alternative proposal, the creation of a new goal for rural electric cooperatives and the reinvigoration of government supervision of the cooperatives that seek to pursue that goal. Important commentators have asked why RECs should continue to exist at all given that their original goal—rural electrification—has been met, since they continue to rely on cheap government loans, and they have poor corporate governance structures that virtually guarantee life tenure to management. Perhaps recognizing their decreasing relevance in today's world, some cooperative leaders have proposed that their organizations would be the ideal providers of high-speed internet access to underserved rural areas. These suggestions may well bear fruit given the current federal interest in expanding rural broadband internet services.²¹ We document the present state of these efforts, both in selected state legislatures and on the ground. This proposal would be massively expensive, requiring a huge federal and state investment. While it is not clear that political will exists to provide the necessary financing, we assume that policymakers may agree to do so and go on to suggest that, if this occurs, government regulators would need to engage in serious new forms of monitoring management at these companies to avoid a repetition of the corporate governance failures that have occurred in the past.

We conclude with a short summary of our arguments and their policy implications.

I. WHY COOPERATIVES?

Cooperatives are “firm[s] . . . owned by [the] suppliers of [their] inputs, [their] workers, or [their] customers.”²² In an economy where the investor-owned firm appears to be the standard model, why do we have cooperatives?²³ In legal literature, Henry Hansmann's book, *THE OWNERSHIP OF ENTERPRISE*, provides the best-known account of cooperatives.²⁴ The book,

21. See Collins, *supra* note 19.

22. Peter Molk, *The Puzzling Lack of Cooperatives*, 88 TUL. L. REV. 899, 901 (2014).

23. While most accounts seem to deem the investor-owned firm as the paradigm for all firms, there is a countercurrent of support for cooperatives, often from those on the left. U.S. Senator Bernie Sanders, for instance, has made encouragement of worker-owned cooperatives part of his platform. See *Agenda for America: 12 Steps Forward*, SANDERS.SENATE.GOV, <https://www.sanders.senate.gov/agenda/> (last visited Sept. 5, 2018).

24. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996). Apart from Hansmann's work, discussions of cooperatives in legal literature are fairly rare, except for discussions of certain specific types (e.g., housing cooperatives or mutual insurance companies). *But see* Molk, *supra* note 22, 899–958; Elaine Waterhouse Wilson, *Cooperatives: The First Social Enterprise*, 66 DEPAUL L. REV. 1013 (2017); Patrick A. Tighe, Note, *Underbanked: Cooperative Banking as a Potential Solution to the Marijuana-Banking Problem*, 114 MICH. L. REV. 803 (2016). For recent developments in cooperative law,

which extends beyond traditional cooperatives to discuss investor-owned and nonprofit firms, attempts to explain why in some industrial sectors firms are owned by investors, while in others ownership is typically assigned to producers or consumers of the firm's products or to the firm's workers.²⁵ Largely dismissing theories that see ownership arrangements as the result of ideology, historical quirks, or national peculiarities,²⁶ the book explains ownership arrangements by seeing them as, effectively, a rational answer to the question of which "assignment of ownership" would, in this field, "minimize[] the total costs of transactions between the firm and all of its patrons"?²⁷ The answer is that

[t]he least-cost assignment of ownership is . . . that which minimizes the sum of all of the costs of a firm's transactions. . . . [T]he sum of (1) the costs of market contracting for those classes of patrons that are not owners and (2) the costs of ownership for the class of patrons who own the firm."²⁸

In other words, an ownership form is chosen because it minimizes transaction and ownership costs.

An illustration may help—take farmers' marketing cooperatives. In a number of agricultural sectors—ranging from oranges to dairy to cranberries—producer-owned cooperatives dominate distribution. This ownership arrangement is efficient, in Hansmann's account, because it minimizes costs. First, it minimizes farmers' costs because, for them, there is a high cost to not owning the distributor. For these products, middlemen tend to have "monopsony power over the farmers they deal with," giving farmers a strong economic incentive to join together, either to bargain collectively with the middlemen or to displace them entirely by taking ownership of the distributor.²⁹ While the cost of not owning would be high, the cost of owning (agency costs) is fairly low in these fields. According to Hansmann, when they organize cooperatives for these products, "[f]armers have both the incentive and the opportunity to monitor marketing cooperatives active-

see Brett H. McDonnell, *Three Legislative Paths to Social Enterprise: L3Cs, Benefit Corporations, and Second Generation Cooperatives*, in *CAMBRIDGE HANDBOOK ON SOCIAL ENTERPRISE* (Benjamin Means & Joseph W. Yockey eds., 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2964018.

25. HANSMANN, *supra* note 24, at 12–16. Hansmann notes that in one view investors are just one more kind of patron, as suppliers of capital.

26. *See, e.g., id.* at 4 (asserting that the study of alternative forms of ownership "permits us to appreciate the processes and the speed with which anachronistic organizational forms are replaced by more efficient ones"); *id.* at 7 (discounting "national" explanations for organizational forms). For a critique, see Neil Fligstein, *The Organization of Enterprise*, 103 *AM. J. SOC.* 823, 824 (1997) (book review) ("Theories that emphasize the role of history, accident, or preexisting political and legal institutions are never given adequate consideration either as theories or in the evidence in any systematic way.").

27. HANSMANN, *supra* note 24, at 21.

28. *Id.* at 22.

29. *Id.* at 122–23.

ly and intelligently.”³⁰ These farmers have a huge economic investment in their crop, tend to be geographically concentrated, and have homogenous interests (all wanting the highest price for the crop).³¹ This is not true for all agricultural products, but in fields where it is, producers’ cooperatives prevail.³² In other fields where the elements have different values—where cost of ownership may be higher or cost of market contracting lower—other ownership arrangements predominate. Having developed a general theory of enterprise ownership, Hansmann then tests it against a number of industries, including utility ownership and, particularly, RECs.³³

Hansmann does not go into great depth in discussing the historical origins of RECs, but his theoretical explanation for their success is illuminating. Applying the template set out above, Hansmann notes that local electrical networks are “natural monopolies” that potentially leave consumers open “to serious price exploitation if they were to rely on market contracting with an investor-owned firm.”³⁴ Rate regulation is one way to control the costs consumers would incur were their networks investor-owned, but such regulation works imperfectly and imposes its own costs. “By aligning the firm’s interests with those of its customers,” however, a consumer-owned electric cooperative can allow consumers to avoid both the costs of monopoly and those of rate regulation.³⁵ While consumers’ costs of not owning the power distributor are high, the costs of consumers owning RECs are, in this account, low, as rural cooperative members are “a dominant group of patrons with relatively homogenous interests.”³⁶ In other words, he deduces that, given these conditions, rural electric cooperatives are an efficient organizational form.

Hansmann provides a high-level view of why it may be economically rational for rural electricity to be provided by consumers’ cooperatives, but he does not (albeit understandably) focus on the governance dysfunctions we identify in this Article as plaguing RECs. He does, however, acknowledge that it is possible in some areas for governance problems to persist. In *THE OWNERSHIP OF ENTERPRISE*, Hansmann notes that stagnation or “inertia” may develop in the choice of organizational forms, particularly in areas that (1) lack established brokers and procedures to facilitate an entity’s change from one organizational form to another and (2) have

30. *Id.* at 134.

31. *Id.* at 134–36.

32. *Id.* at 140. Hansmann is clear that, with some crops, there is greater conflict among producers, and in such fields, producers’ cooperatives do not flourish. *Id.* at 137–39.

33. *See id.* at 168–73.

34. *Id.* at 169.

35. *Id.* at 170.

36. *Id.* Interestingly, Hansmann explains the lack of urban electric cooperatives partly by the heterogeneity among urban electricity consumers, which would raise the cost of ownership. *Id.* at 174–76.

managers who are not effectively controlled by owners and thus have the power to block changes in ownership structure.³⁷ Managers are particularly likely to be successful in such maneuvers, he writes, “where, as in many cooperative and mutual firms, shares in ownership are not freely marketable.”³⁸ Thus, he concludes, “[T]here are industries in which anachronistic forms of ownership have remained firmly embedded long after they have lost their original efficiency advantage over other forms.”³⁹ Our account below suggests this is the case with RECs.

While takeovers and the market for corporate control are also not discussed at any length in Hansmann’s book, there is an intriguing mention that, early in the twentieth century, many insurance companies’ decisions to move from the stock form to the mutual form (i.e., from investor to customer ownership) “was motivated in substantial part by the managers’ desire to avoid being displaced by a corporate takeover,” lending credence to the idea that customer ownership is a barrier to takeovers.⁴⁰ Peter Molk, in a recent article, also noted in passing that agency costs in cooperatives are reputed to be higher than in investor-owned firms “since cooperatives lack the takeover threat that keeps investor-owned firms honest because cooperative ownership generally cannot be aggregated by a potential acquirer.”⁴¹

II. COOPERATIVES AND RURAL ELECTRIFICATION

The cooperative as a business form has a long, if uneven, history in the United States.⁴² In the nineteenth century, attempts at organizing either consumers’ or producers’ cooperatives often went hand in hand with radical movements challenging the growing power of large corporations, and visionaries spoke of replacing *laissez-faire* capitalism with an ill-defined “cooperative commonwealth.”⁴³ Consumers’ cooperatives could be found in connection with various utopian socialist movements as early as the 1820s, while later in the century cooperative stores and buying clubs were started by unions such as the Knights of Labor.⁴⁴ Due in part to the fact they were guided by political as much as economic calculations, many of these failed after a relatively short period, and even those that survived re-

37. *Id.* at 46.

38. *Id.*

39. *Id.* To be clear, this is a general observation of Hansmann’s not specifically about RECs.

40. *Id.* at 275.

41. Molk, *supra* note 22, at 926 n.118.

42. *See generally* JOHN CURL, FOR ALL THE PEOPLE: UNCOVERING THE HIDDEN HISTORY OF COOPERATION, COOPERATIVE MOVEMENTS, AND COMMUNALISM IN AMERICA (2009) (giving an encyclopedic and uncritical account of cooperative movements in the United States).

43. *See* ALEX GOUREVITCH, FROM SLAVERY TO THE COOPERATIVE COMMONWEALTH: LABOR AND REPUBLICAN LIBERTY IN THE NINETEENTH CENTURY 86–88 *passim* (2015).

44. *Id.* at 36–37.

mained at the margins of the larger commercial economy.⁴⁵ After the Civil War, agrarian populist movements embraced the cooperative form as well. In the 1870s and 1880s, the radical Grange and Farmers' Alliance organized marketing and purchasing cooperatives in an attempt to cut out middlemen and give farmers the organizational heft enjoyed by the railroads and other large capitalist endeavors.⁴⁶ While, for the most part, these efforts collapsed after a few years, they served to introduce cooperative ideas to rural America.⁴⁷

It was in agriculture that cooperatives survived and flourished. Shorn of their radical politics, producers' cooperatives in agriculture became well-established, particularly in the Pacific states and the Midwest, operating "cooperative grain elevators, creameries, cheese factories, and livestock rings."⁴⁸ By the 1920s, they were actively encouraged by the federal government through the Department of Agriculture and were even given exemptions from antitrust law.⁴⁹ But such marketing organizations were large and departed in many respects from the "classic" idea of a cooperative—for instance, in a number of states cooperatives could sell stock.⁵⁰ Except in name, they little resembled consumers' cooperatives, which had some presence but were never a major factor in the American economy. How then did consumers' cooperatives become the vehicle for one of the New Deal's major programs, rural electrification?

In many situations, the cooperative form is freely chosen by organizers who determine that a cooperative will best suit their needs.⁵¹ That was not the case with RECs. Widespread use of cooperatives for rural electrification was produced by the confluence of three strands in American history, none of which simply involved selection of an economically optimal business form: first, the desire to improve what was seen as an economically and culturally impoverished countryside; second, the war against private electric utilities waged in the 1920s and 1930s; and third, the long tradition of agricultural cooperation. As these strands came together in the Great Depression and New Deal, they resulted in an essentially *political* decision to use cooperatives to electrify the countryside, a decision carried out by a federal agency, the REA, which not only provided loans to these new cooperatives but also, in a very real sense, constructed them, being deeply

45. See *id.* at 67–68.

46. See CHARLES POSTEL, *THE POPULIST VISION* 103–33 (2007).

47. See VICTORIA SAKER WOESTE, *THE FARMER'S BENEVOLENT TRUST: LAW AND AGRICULTURAL COOPERATION IN INDUSTRIAL AMERICA, 1865–1945*, at 22–25 (1998).

48. RONALD R. KLINE, *CONSUMERS IN THE COUNTRY: TECHNOLOGY AND SOCIAL CHANGE IN RURAL AMERICA* 29 (2000). Farmers also organized for purchasing, but the marketing cooperatives seemed to be more successful and visible.

49. See WOESTE, *supra* note 47, at 157–63.

50. *Id.* at 64–66.

51. See, e.g., *id.* at 17–59.

involved in every step of their workings from initial organization to construction of lines and ongoing operations.

A. *The Dream of Rural Electrification*

The dream of bringing electricity to the farm can be traced back to early twentieth century beliefs that there was a growing divide between country and city and that the countryside was falling behind.⁵² Since the nation's founding, farmsteads had been perceived as wellsprings of virtue, compared to decadent cities; Thomas Jefferson once wrote that "[c]ultivators of the earth are the most valuable citizens . . . [t]hey are the most vigorous, the most independent [sic], [and] the most virtuous."⁵³ By the early twentieth century, however, cities were growing much faster than rural areas,⁵⁴ and the image of the farmer as a hardy yeoman began to be replaced by that of an out-of-touch bumpkin. Increasingly, rural America was seen as a problem. In 1909, Theodore Roosevelt established a Country Life Commission, which "warned that the 'incubus of ignorance and inertia [was] so heavy and widespread' in rural America 'as to constitute a national danger.'"⁵⁵ According to the Commission, a major reason that rural America lagged behind the cities was that it lacked access to electric power—important both for civilizing the lives of farmers and for improving farm productivity—and thus, the Commission recommended that farmers should be provided "power, on reasonable terms, for cheap transportation, for lighting their homes, and for innumerable uses in the daily tasks on the farm."⁵⁶ The Commission even suggested that farmers might use cooperatives to construct electrical lines.⁵⁷ At this time, however, hopes for rural electrification were not accompanied by significant state or federal action. Nor did it appear that farmers themselves were ready to start large-scale electrification via cooperatives; in one area, telephone service, there was a fair number of rural cooperatives operating, but despite superficial similarities, stringing telephone wires was far less expensive and technologically challenging than stringing power lines. So one activity did not lead to the other.⁵⁸

52. See *infra* notes 54–57 and accompanying text.

53. Letter from Thomas Jefferson to John Jay (Aug. 23, 1785), in 8 THE PAPERS OF THOMAS JEFFERSON 426, 426 (Julian P. Boyd et al. eds., 1953).

54. *Rural and Urban Places, Table Aa716–775: Population, by Race, Sex, and Urban-Rural Residence: 1880–1990*, HIST. STAT. U.S.: MILLENNIAL EDITION ONLINE (2006), <https://hsus.cambridge.org/HSUSWeb/toc/showTablePdf.do?id=Aa716-775>.

55. POSTEL, *supra* note 46, at 282 (quoting COUNTRY LIFE COMM'N, REP., S. DOC. NO. 60-705, at 55 (2d Sess. 1909)); see also DAVID E. NYE, ELECTRIFYING AMERICA: SOCIAL MEANINGS OF A NEW TECHNOLOGY, 1880–1940, at 288–91 (1990).

56. NYE, *supra* note 55, at 288 (quoting S. DOC. NO. 60-705).

57. See S. DOC. NO. 60-705, at 58–59.

58. KLINE, *supra* note 48, at 26–27.

A major barrier to rural electrification was private utilities' firm belief that it would not pay off. As discussed below, private power generation and distribution was a major political issue in the 1920s and 1930s, and partly because of that, several experiments in rural electrification were tried by individual companies or industry groups, apparently less to test out the business than to pacify angry politicians. As early as 1910, the industry lobby, the National Electric Light Association (NELA), set up a Committee on Electricity in Rural Districts (CERD), but for the most part it concluded that rural electrification was not feasible; a 1913 report stated that the farm business, "as developed at present, does not furnish the central-station companies with returns commensurate with the necessary capital investment."⁵⁹ Through the rest of the decade and into the 1920s, the industry consistently claimed that rural electrification would be unprofitable. In the early 1920s, the NELA launched pilot electrification projects near Red Wing, Minnesota, and in several rural communities in Alabama.⁶⁰ While farmers welcomed the power, the utility companies concluded that the experiments showed that widespread, universally available rural electrification was still not economical, in good part because of the tremendous upfront investment required to build high-voltage lines and wire farmsteads and to assist farmers in purchasing appliances. Even when rural areas were wired, rates charged to the small number of farmers who received power tended to be about double those charged to urban users.⁶¹ As one critic observed, before the mid-1920s, "practically all references to rural electrification had been casual or limited to a high-cost service."⁶²

In a handful of locations, rural consumers did form cooperatives to distribute electricity, but these were isolated endeavors with mixed results. Before the early 1930s, roughly fifty electric cooperatives had been formed, most in the Midwest, which had a tradition of cooperatives, and in the Pacific Northwest, where government-generated hydropower offered more attractive wholesale rates.⁶³ "Typically membership ranged from fifty to 200 families."⁶⁴ While some succeeded, many failed due to poor management, technical failures, and hostility by the private utility companies

59. JOHN L. NEUFELD, *SELLING POWER: ECONOMICS, POLICY, AND ELECTRIC UTILITIES BEFORE 1940*, at 209 (2016).

60. *Id.* at 213–15.

61. *See* D. CLAYTON BROWN, *ELECTRICITY FOR RURAL AMERICA: THE FIGHT FOR THE REA* 5 (1980).

62. Morris Llewellyn Cooke, *The Early Days of the Rural Electrification Idea: 1914–1936*, 42 *AM. POL. SCI. REV.* 431, 438–39 (1948).

63. *See* BROWN, *supra* note 61, at 14–15; KLINE, *supra* note 48, at 100–01.

64. BROWN, *supra* note 61, at 14.

that sold power to the cooperatives.⁶⁵ Even those cooperatives that succeeded were sometimes sold to private utilities.⁶⁶

Publicly owned power companies did exist in the United States, with many municipalities owning their own generating stations and distribution systems, but they never served more than 20% of all power customers in the nation.⁶⁷ Most electricity customers were served by private utilities, whose rates were regulated by public utility commissions often suspected of being in the private companies' pockets.⁶⁸ A significant political issue in the 1920s and early 1930s was the size of these privately owned utilities, which were rapidly being assembled into pyramided utility holding companies.⁶⁹ By the end of the 1920s, seven holding companies controlled a majority of power generation in the United States, with three controlling over 42% of all private power generation.⁷⁰ These holding companies were attacked not only because of their size, but also because of critics' belief that their often-byzantine structures—with webs of cross-ownership and intra-organization sales of assets and power—disguised their actual financial conditions, enabled sales of securities far more risky than they appeared, allowed gaming of utility regulations by inflating the value of operating firm assets, and gave owners with claims on only small amounts of corporate profits control of vast agglomerations of wealth.⁷¹ Debates over power in this decade thus took place against the background of the holding companies, and disputes over rural electrification became disputes over whether power should be generated privately or publicly.

Advocates for rural electrification pointed out that in other nations the countryside was electrified with direct government involvement. A frequently cited example lay across the border in Ontario, where government-owned Hydro Ontario provided low-cost power to rural consumers.⁷² Government involvement was similarly credited for remarkably high rates of rural electrification in European nations such as Sweden, Czechoslovakia, Germany, and France, though critics correctly pointed out that this was often accomplished through heavy government subsidization and that basic conditions in those nations were often different than those in the United

65. *Id.* at 15.

66. *Id.*

67. NEUFELD, *supra* note 59, at 26 fig.2.1.

68. *See id.* at 64–72.

69. The classic reference is JAMES C. BONBRIGHT & GARDINER C. MEANS, *THE HOLDING COMPANY* (1932), which devotes most of its space to utility holding companies. NEUFELD, *supra* note 59, is an excellent contemporary guide.

70. NEUFELD, *supra* note 59, at 97, 115.

71. *Id.* at 97; *see generally* BONBRIGHT & MEANS, *supra* note 69.

72. NEUFELD, *supra* note 59, at 145–47; Cooke, *supra* note 62, at 439–40.

States (e.g., French farmers tended to live together in villages, making it easier to provide them power).⁷³

During the 1920s, however, advocates for public power largely faced defeat. The most significant attempt to challenge private power generation during this period was in Pennsylvania, where progressive governor Gifford Pinchot backed the so-called “Giant Power” plan that would have produced a new power generating and distributing system under tight state supervision. Under Giant Power, generation plants would have been built in Pennsylvania’s coal country and power would have been distributed statewide through a new network of high-voltage lines.⁷⁴ While it involved private power companies, the larger goal of Giant Power was to bring “the spreading net of electric power . . . under public control.”⁷⁵ Notably, Giant Power was committed to rural electrification: one aspect was its proposal that “the Public Service Commission be empowered to require extension of distribution systems to unserved territory; . . . the formation of rural mutual and district distribution companies was authorized and encouraged.”⁷⁶ Unsurprisingly, Giant Power faced bitter opposition from private interests and was rejected by Pennsylvania’s legislature in 1926.⁷⁷ Only in the 1930s would public control of power generation and distribution become politically viable.

B. *The Great Depression and the Tennessee Valley*

At the beginning of the 1930s, roughly 90% of rural residents—those living in “unincorporated areas or in incorporated towns and villages with populations of fewer than 1,500”—lacked access to electrical power.⁷⁸ The numbers were somewhat better for a few states in the Northeast and Pacific coast, where farms benefitted from proximity to urban centers or public hydropower, but this was balanced out by the many states, particularly in the South, where less than 5% of rural households had power.⁷⁹ These numbers had improved during the 1920s—at the beginning of that decade,

73. See BROWN, *supra* note 61, at 16.

74. Thomas Parke Hughes, *Technology and Public Policy: The Failure of Giant Power*, 64 PROC. IEEE 1361, 1361–63 (1976); see also NEUFELD, *supra* note 59, at 90–95.

75. Hughes, *supra* note 74, at 1368.

76. *Id.* at 1365.

77. *Id.* at 1371.

78. Paul Wolman, *The New Deal for Electricity in the United States, 1930–1950*, in THE CHALLENGE OF RURAL ELECTRIFICATION: STRATEGIES FOR DEVELOPING COUNTRIES 259, 266 (Douglas F. Barnes ed., 2007) (using Census data to conclude only 12.6% of farm and village households had electricity); see also TWENTIETH CENTURY FUND POWER COMM., ELECTRIC POWER AND GOVERNMENT POLICY 441–42 (1948) (reporting that in 1931 10.4% of farms had electricity).

79. See NYE, *supra* note 55, at 299–300, 299 fig.7.2.

only 2% of rural Americans living on a farm had power—but it was slow progress.⁸⁰

The stock market crash of 1929 and the election of Franklin Roosevelt three years later set the stage for a new push for rural electrification. The crash undermined the utility holding companies and public support for private power; “[b]etween 1929 and 1936, eighty-two holding companies . . . had defaulted on [their] bonds or had gone into bankruptcy or receivership,” causing losses for many holding their securities.⁸¹ Why much of the fight over public power eventually focused on the valley of the Tennessee River, though, is a tale of both geography and politics.

In the 1920s, the watershed of the Tennessee River—an area including most of Tennessee but drawing on seven other states as well—was a byword for backwardness and lack of development, suffering unpredictable flooding as well as the deprivation that typified the rural South. What galled many progressive politicians was that one stretch of the river, Muscle Shoals in north Alabama, also had extraordinary potential as a source of hydropower due to a rapid drop in elevation.⁸² During World War I, construction began on Wilson Dam at Muscle Shoals to power wartime munitions production, but it was left unfinished at the war’s end.⁸³ Throughout the 1920s a sharp battle was waged over what was to become of Muscle Shoals; “Congress may have devoted more time to fighting over the disposition of this white elephant than to any other single issue” in that decade.⁸⁴ Influential Nebraska Senator George W. Norris pushed to have the site developed by the federal government to generate public power, against bitter opposition from private interests.⁸⁵ The stalemate was broken only with the 1932 election and Roosevelt’s support of an entirely new use for the Shoals and the river.

The Tennessee Valley Authority Act was one of a series of ambitious acts passed during the first 100 days of the New Deal.⁸⁶ Roosevelt had a longstanding interest both in public power, from his days as Governor of New York, and in Southern rural poverty, which he saw during his stays in Warm Springs, Georgia.⁸⁷ The Act was a bold move in favor of public power as part of an effort to remake an entire region. Under the Act, TVA, a federally owned corporation, would finish the development of Muscle

80. See NEUFELD, *supra* note 59, at 203.

81. *Id.* at 115.

82. See PHILIP J. FUNIGIELLO, TOWARD A NATIONAL POWER POLICY 34–36 (1973).

83. *Id.* at 33–34.

84. NEUFELD, *supra* note 59, at 170.

85. *Id.* at 170–71.

86. See DAVID M. KENNEDY, FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR, 1929–1945, at 147–53 (1999).

87. See generally *id.*

Shoals, build additional dams for flood control and hydropower generation, “produce fertilizers, . . . combat soil erosion and deforestation, . . . upgrade health and educational services in the depressed valley, . . . [and] attract new industries to the region.”⁸⁸ The Act called for completion and public ownership of Muscle Shoals so that “through the distribution of power to the rural and back-hill country of the Tennessee Valley the life of its inhabitants, long considered economically and socially backward, may be advanced.”⁸⁹ While the Act allowed TVA to sell power to private entities, it gave preference in power sales “to states, counties, municipalities, and ‘co-operative organizations of citizens or farmers’” and made clear that TVA should act for the benefit of “rural consumers.”⁹⁰ Within a few months, TVA announced it would sell power it generated to municipal systems at rates sharply lower than those charged by private power generators, fulfilling one of its founders’ goals by providing a “yardstick” against which to measure private power rates.⁹¹

Under TVA, rural electrification began with a cooperative. In 1934, TVA encouraged individuals in Corinth, Mississippi, to organize a cooperative to purchase and distribute power to local consumers—this became the Alcorn County Electric Cooperative.⁹² The choice of location was not random; Corinth sat within the district of powerful Congressman John Rankin. The Alcorn cooperative’s origins point towards later developments; while TVA publicity portrayed it as the product of local initiative, TVA director David Lilienthal managed to be present at its incorporation meeting, suggesting a guiding hand.⁹³ It also benefited from government support in other ways. While private utilities had always insisted that rural consumers had to pay in advance for high-voltage wires leading to farmsteads, the Alcorn co-op used a low-interest loan from TVA to pay for the wires, and consumers were also eligible for loans to purchase electric appliances from another federal agency, the Electric Home and Farm Authority.⁹⁴ The Alcorn experiment was a success, at least in TVA’s eyes, apparently demonstrating that distributing and selling power to rural con-

88. *Id.* at 148.

89. Comment, *The Tennessee Valley Authority Act*, 43 *YALE L.J.* 815, 818 (1934).

90. Cooke, *supra* note 62, at 443 (quoting Tennessee Valley Authority Act of 1933, 16 U.S.C. §§ 831i–831j (2012)).

91. In a 1932 speech, Roosevelt spoke of government power developments that could serve as a “yardstick to prevent extortion against the public.” B.W. Patch, *Rural Electrification and Power Rates*, in 2 *EDITORIAL RESEARCH REPORTS* (1934) (quoting Franklin D. Roosevelt, Campaign Speech at Portland, Oregon (Sept. 21, 1932)), <http://library.cqpress.com.libdata.lib.ua.edu/cqresearcher/document.php?id=cqresrre1934120400&type=hitlist&num=0>.

92. BROWN, *supra* note 61, at 36–39.

93. *Id.* at 37–38.

94. *Id.* at 38–39; see also Gregory B. Field, “Electricity for All”: *The Electric Home and Farm Authority and the Politics of Mass Consumption, 1932–1935*, 64 *BUS. HIST. REV.* 32, 36 (1990).

sumers could pay.⁹⁵ Its net income far outstripped expectations, and “[a]t such a rate of progress the co-op’s indebtedness to TVA could be paid in five and one-fourth years, rather than the projected twelve to fourteen years.”⁹⁶ As the REA’s historian later put it, “[b]y combining low cost energy with loans for appliances, TVA broke the cycle of expense of the rural electric customer and put electrification within the range of the farmer’s pocketbook.”⁹⁷

The success of a single cooperative in rural Mississippi, however, did not immediately translate to a national program of rural electrification. For one, it was easy to point to the ways that the Alcorn experiment relied on unusual circumstances, including interconnection with a municipal power grid and low-cost power and loans from TVA. The question remained as to whether this model could be replicated and scaled; it also remained as to how the New Deal proposed to electrify the rest of rural America.

C. *Creating the Rural Electrification Administration*

While many individuals in the New Deal were sympathetic to rural electrification, the movement’s guiding force was Morris Llewellyn Cooke, who, by the time he came to Washington in 1933 to work for the New Deal, already had decades of experience in public power, including work on Pennsylvania’s Giant Power proposal.⁹⁸ He had extensively studied issues with rural electrification and had concluded from Giant Power that industry objections that electrification would not pay were wrong; in particular, he argued that industry estimates of the cost of high-voltage wiring were far too high.⁹⁹ When the REA was formed in 1935, partly in response to pressure from agricultural groups seeking power for their constituents, Cooke was the logical choice to run it.¹⁰⁰

The REA began as a works relief program, which was authorized in the Emergency Relief Appropriations Act passed in May 1935.¹⁰¹ The Act as a whole authorized almost \$5 billion for public works, with \$100 million dedicated to rural electrification.¹⁰² Despite the emphasis on “relief,” sug-

95. Alcorn also served the city of Corinth, Mississippi, so it was not serving only rural customers. BROWN, *supra* note 61, at 37.

96. *Id.* at 37.

97. *Id.* at 39; *see also* Wolman, *supra* note 78, at 273–75.

98. *See generally* Sondra Van Meter McCoy, *Cooke, Morris Llewellyn*, AM. NAT’L BIOGRAPHY (Feb. 2000), <https://doi.org/10.1093/anb/9780198606697.article.0600108>.

99. *See* BROWN, *supra* note 61, at 35–36.

100. For a discussion on the maneuvering leading up to establishment of the REA, *see id.* at 35–45.

101. FUNIGIELLO, *supra* note 82, at 136–38; *see also* Exec. Order No. 7037, Establishing the Rural Electrification Administration (May 11, 1935).

102. *See* BROWN, *supra* note 61, at 45.

gesting the need for the REA to employ laborers, Roosevelt was persuaded to restructure it as an agency chiefly giving out loans, and it was as a lender that the REA originally entered the field.¹⁰³

Despite recurring suggestions that rural electrification should be accomplished through cooperatives, Cooke turned initially to private utilities for assistance. While cooperatives had played a major role in rural electrification in several European nations, they had a mixed record with electrification in the United States, and there were, at best, only a handful of successful ones.¹⁰⁴ As one historian explained, “Cooke had to spend the \$100,000,000 quickly[,] and only the companies had the equipment and personnel to go into action on short notice.”¹⁰⁵ But private power companies were skeptical both that rural electrification was even possible without massive government subsidies and of any program proposed by an administration that was, at that moment, trying to break up the utilities holding companies.

In May 1935, the month the REA was authorized, Cooke held a two-day meeting with fifteen representatives of the private power industry to measure their interest in rural electrification. At the meeting’s end, he was so optimistic about their involvement that he announced that 95% of REA money would be loaned to private utilities.¹⁰⁶ In July, however, the industry representatives submitted a plan that they should have known would be entirely unacceptable. They proposed that the REA loan private companies over \$113 million—more than the agency had been allotted—in return for which they would connect “351,000 prospective rural customers of which 247,000 were farmers”;¹⁰⁷ this when over 5 million of the nation’s 6 million farms lacked power. Furthermore, they refused either to guarantee the rates to be charged farmers or to offer the comprehensive “area coverage” for all farms in a region desired by the REA.¹⁰⁸ Finally, their proposal seemed to mock the idea of rural electrification, calling farmers the “most favored” class of customers and claiming that “there are very few farms requiring electricity for major farm operations that are not now served.”¹⁰⁹

Undoubtedly, the industry plan was driven by the settled belief that widespread rural electrification was uneconomical, but it also came in the middle of a political fight in which the private companies were battling the

103. H. S. Person, *The Rural Electrification Administration in Perspective*, 24 *AGRIC. HIST.* 70, 73–74 (1950).

104. See UDO RALL, *FED. EMERGENCY RELIEF ADMIN., A STUDY OF COOPERATIVE CONSUMER ASSOCIATIONS FOR RURAL ELECTRIFICATION* 5 (1935).

105. BROWN, *supra* note 61, at 48.

106. FUNIGIELLO, *supra* note 82, at 139.

107. BROWN, *supra* note 61, at 50.

108. *Id.*

109. *Id.*

Roosevelt Administration's attempt to break up the holding companies (a fight the companies lost later that year).¹¹⁰ Whatever its reason, the utilities' crabbled proposal effectively killed the possibility of rural electrification through industry cooperation with the REA. When Cooke discovered that legal difficulties would block a second option for rural electrification, the expansion of municipally owned utilities into the countryside, he was left with cooperatives.¹¹¹ Out of the REA's first ten loans for electrification, seven went to cooperatives,¹¹² and by the end of the 1930s, out of approximately seven-hundred loans, 90% had gone to cooperatives.¹¹³

A year later the REA was established as a permanent administrative agency by the Rural Electrification Act (the Norris-Rayburn Act), which made clear that the REA should give preference in making loans to municipal power and "cooperative, nonprofit, or limited-dividend associations."¹¹⁴ The Norris-Rayburn Act authorized the REA to loan \$50 million in its first year and \$40 million a year thereafter (soon to rise to \$100 million annually) to finance "construction and operation of . . . electric transmission and distribution lines or systems for the furnishing of electric energy to persons in rural areas who are not receiving central station service."¹¹⁵

D. Making Rural Electric Cooperatives

Reliance on cooperatives created problems of its own. Advocates of rural electrification had long looked to cooperatives as a way to distribute power, but few electric cooperatives existed in the early 1930s, and almost none were in the region most in need of electric wires, the South. As the REA's chief economist noted, many farmers did have experience with marketing cooperatives, but those operated far differently than would electric cooperatives, "all of whose capital would be borrowed from the Government and invested in [a] fixed plant of a technical nature requiring a high degree of professional skill for construction and successful operation."¹¹⁶ New cooperatives would have to be established across the nation. Initially the REA, which was seemingly in the best position to make this

110. NEUFELD, *supra* note 59, at 147–51.

111. Some municipal utilities lacked legal authority to expand beyond city limits, while others feared pushback from state legislatures if they did so. See BROWN, *supra* note 61, at 52.

112. MARQUIS CHILDS, *THE FARMER TAKES A HAND: THE ELECTRIC POWER REVOLUTION IN RURAL AMERICA* 62 (1952).

113. Udo Rall, *Cooperative Rural Electrification in the United States*, 18 ANNALS PUB. COOPERATIVE ECON. 194, 200 (1942).

114. Rural Electrification Act of 1936, ch. 432, § 4(a), 49 Stat. 1363, 1365 (codified as amended at 7 U.S.C. § 904 (2012)).

115. *Id.* Rural areas were defined in § 13.

116. Person, *supra* note 103, at 76.

happen, was reluctant to be involved because of concerns that “as a lending agency it could not properly call proposed borrowers into existence if it wished to reserve discretion to refuse loans,” and the assumption drawn from the then-extant cooperative movement “that healthy cooperatives cannot be called into existence by external promotion.”¹¹⁷ Without outside help, though, electric cooperatives were slow to form; by mid-1937 the REA was able to find qualified borrowers for only \$59 million of the \$150 million it had to distribute. Unless more cooperatives appeared, rural electrification threatened to stall.¹¹⁸

It soon became clear that in order for the REA to succeed, it would need to not merely fund cooperatives but to create them. While Cooke had favored a hands-off approach, he retired early in 1937, and his successor, John Carmody, took a more aggressive stance. Under Carmody, the REA would become involved in every aspect of cooperative development, “reach[ing] down into the grass roots of rural America” and “dispatch[ing] hundreds of agents into the field to guide local borrowers in the mechanics of applying for loans and in working up suitable projects.”¹¹⁹ By 1942, one study would find that many cooperatives

were brought into existence by REA [and] all have been guided and supervised by it . . . REA’s influence has pervaded all of them—in organization, system design and construction, general policy, and management. It might almost be said . . . that the cooperatives are district offices in an organization of which REA is the home office.¹²⁰

The REA’s work began with the legal infrastructure for electric cooperatives. Like much in the American legal system, the laws governing cooperatives were a patchwork before the mid-1930s.¹²¹ Some state laws did not allow nonprofit associations to run electric cooperatives at all, while others placed onerous burdens on organizers; “Connecticut, for example, required an act of the legislature before the creation of any new electric concern.”¹²² Where they were allowed, rules varied on whether the cooperatives fell under the supervision of the state utilities commissions.¹²³ It was also unclear whether electric cooperatives had the power of eminent domain. To rectify this confusion, in 1939 the REA drafted a model Rural Electric Cooperative Act (the Model Act), which drew on an earlier model

117. *Id.* at 77.

118. *See id.*

119. FUNIGIELLO, *supra* note 82, at 163.

120. FREDERICK WILLIAM MULLER, PUBLIC RURAL ELECTRIFICATION 69 (1944).

121. *See, e.g.,* WOESTE, *supra* note 47, at 64–66 (discussing cooperatives with capital stock).

122. NEUFELD, *supra* note 59, at 227.

123. *See id.*

act developed in 1934 by the Public Works Administration.¹²⁴ By 1941, about half of all the states had adopted some form of these acts (the State Model Acts).¹²⁵ The State Model Acts provided detailed requirements for cooperative governance, emphasizing the membership's power to oversee the cooperative (discussed below), but it also removed barriers to cooperatives by, for instance, granting them the power of eminent domain, limiting state taxation, and removing them from scrutiny of state utility commissions.¹²⁶

The REA also established a series of divisions to help incorporators organize their cooperative, construct its infrastructure, and manage its ongoing operations. As longtime REA staffer Udo Rall wrote in 1942, these steps were made necessary by the "lack of experience on the part of the farmers in organizing, constructing and operating such electric distribution enterprises."¹²⁷ The REA's Examining Division was charged with supervising development of the cooperative up to the time it received loans, assisted by the Legal Division, which drafted individual cooperatives' articles of incorporation, loan contracts, and mortgages. The REA's Division of Engineering and Operations would then provide "engineering and management advice . . . during and after the period of construction of a system."¹²⁸ Finally, the REA's Finance Division had field auditors who would "assist local management in setting up the proper bookkeeping and accounting procedure" and periodically auditing a cooperative's books.¹²⁹ For a cooperative, thoroughgoing REA involvement and supervision was unavoidable, as only the REA could provide both technical assistance and the generous and below-market-rate loans needed to build the distribution network.¹³⁰

Impetus to organize a cooperative usually began locally, sometimes with individuals hearing of the REA by word of mouth and writing for more information,¹³¹ sometimes with initiatives from local granges, farmers' bureaus, or congressmen's offices.¹³² Once organization began and local officers were selected, they would "canvass[] the area for potential

124. DRAFT OF RURAL ELEC. COOP. ACT 3, introductory cmt. (RURAL ELECTRIFICATION ADMIN. 1939).

125. TWENTIETH CENTURY FUND POWER COMM., *supra* note 78, at 451 n.43.

126. DRAFT OF RURAL ELEC. COOP. ACT 4-5, introductory cmt.

127. Rall, *supra* note 113, at 198.

128. *Id.*

129. *See id.* at 199.

130. REA loan rates stayed around 3% through the 1930s, whereas comparable private loans "would have been at least 6 percent." Carl Kitchens & Price Fishback, *Flip the Switch: The Impact of the Rural Electrification Administration 1935-1940*, 75 J. ECON. HIST. 1161, 1190 (2015).

131. Brian Q. Cannon, *Power Relations: Western Rural Electric Cooperatives and the New Deal*, 31 WESTERN HIST. Q. 133, 138 (2000).

132. BROWN, *supra* note 61, at 68.

recipients of service.”¹³³ REA attorneys would then become involved in the process of organizing the cooperative in anticipation of a loan application, providing model articles of incorporation and bylaws, while other REA employees would gather information needed to demonstrate that the project could pay off a loan. “Solvency of the co-op . . . was particularly sensitive” to the REA, “based on the likelihood of each co-op meeting not only its loan payments but also the cost of maintenance, insurance, payroll, depreciation and other expenses.”¹³⁴

Assuming the plan was viable, an REA representative would then help the cooperative organize a mass meeting to encourage local membership, explaining to attendees that the REA would make a loan for 100% of the cost of electrification and would “provide supervision and assistance in problems of organization, wholesale and retail rates, engineering and construction, operation and management, and in legal and financial matters.”¹³⁵ Wide membership was pushed because the cooperative’s members were also its customers, and the larger the customer base, the more likely the project was to achieve the widespread “area coverage” that was sought and generate income to pay back its loans.¹³⁶ Once the cooperative was organized and an initial loan made, the REA kept careful watch over construction of the electrical network. Many of the techniques used to build out the high-voltage lines had been developed or improved by the REA, including use of new materials and different spacing of poles, all of which led to sharply lower costs than projected by private utilities. While private companies had predicted that lines would cost as much as \$2,000 per mile, REA reported costs as low as \$872 per mile by the end of the 1930s and \$750 per mile a few years later.¹³⁷ Most cooperatives only distributed power, purchasing it at wholesale rates from private producers, but REA experts often handled the negotiations for the purchasing contract.¹³⁸

Governance of the cooperative was a particular concern of the REA. The overall framework for cooperative governance was drawn from consumers’ cooperatives, which were themselves most often organized by following the Rochdale principles, first developed in England in the 1840s and thereafter used to guide consumers’ cooperatives there and in the United States.¹³⁹ As explained by the REA in a publication for cooperative

133. *Id.* at 69.

134. *Id.*

135. Rall, *supra* note 113, at 203.

136. *Id.* at 200.

137. TWENTIETH CENTURY FUND POWER COMM., *supra* note 78, at 453; *see generally* Rall, *supra* note 113, at 199. Cost estimates appear to have varied based on local conditions and what kinds of maintenance were included in the cost of lines.

138. Rall, *supra* note 113, at 199.

139. For a discussion on Rochdale, see Ellen Furlough & Carl Strikwerda, *Economics, Consumer Culture, and Gender: An Introduction to the Politics of Consumer Cooperation*, in CONSUMERS

members, in the REA's version these principles were simple: "1. Open membership[;] 2. Democratic control, or one member one vote[;] 3. Invested capital gets no profits, only interest[;] 4. Return of gains to the members in proportion to their patronage[;] 5. Political, religious, and racial neutrality[;]"¹⁴⁰ 6. Cash trading, no credit business[;] 7. Education in cooperation."¹⁴¹ The Model Act followed these principles, providing, for instance, for one-member, one-vote governance and limiting distributions to patronage refunds "prorated in accordance with the patronage of the cooperative by the respective members."¹⁴²

But the REA's actual involvement with cooperative governance extended well beyond setting out principles or providing model bylaws.¹⁴³ For one, the REA retained veto power over key employment decisions in a cooperative receiving loans, including choice of a cooperative's lawyer, supervisor, and managers.¹⁴⁴ One REA employee justified this approach in an illuminating comment: such REA involvement was, he stated, a response to "a lack of a sense of responsibility on the part of the borrowers."¹⁴⁵

For all the REA's cheerleading for cooperatives, below the surface ran worries about how well the cooperatives would be run.¹⁴⁶ Too often these worries proved justified; stories about poorly run cooperatives are a recurrent feature of REA publications. In its 1937 annual report, for instance, the REA discussed cooperatives where board members insisted on employing relatives or running related businesses (such as electric appliance sales) in violation of their bylaws, though it also stated that in response it had "insisted upon a complete separation of such activities."¹⁴⁷ In the following year's report, the REA spoke of cooperatives that were mere "hollow shells" but boasted that it and cooperative members attacked such abuses and "usually correction [was] prompt."¹⁴⁸ As one historian characterized this period,

AGAINST CAPITALISM? CONSUMER COOPERATION IN EUROPE, NORTH AMERICA, AND JAPAN, 1840–1990, at 1, 6–10 (Ellen Furlough & Carl Strikwerda eds., 1999).

140. Though beyond the scope of this Article, the identification of "racial neutrality" by the REA is yet another sign of the ways it viewed cooperatives as engaging in active social change.

141. RURAL ELECTRIFICATION ADMIN., A GUIDE FOR MEMBERS OF REA COOPERATIVES 19 (1939) [hereinafter REA MEMBER GUIDE].

142. DRAFT OF RURAL ELEC. COOP. ACT § 20(f) (RURAL ELECTRIFICATION ADMIN. 1939).

143. The REA's model bylaws for electric cooperatives are discussed in MULLER, *supra* note 120, at 74.

144. Cannon, *supra* note 131, at 146–47.

145. *Id.* at 150.

146. See KLINE, *supra* note 48, at 224–25.

147. RURAL ELECTRIFICATION ADMIN., 1937 ANNUAL REPORT 10 (1938).

148. RURAL ELECTRIFICATION ADMIN., 1938 ANNUAL REPORT 41 (1939).

[l]ocally, the REA complained that boards of directors often ran co-ops like private fiefdoms and refused to follow recommendations on how to operate the co-ops. The REA criticized staff and members of co-ops for not showing a cooperative spirit in matters ranging from granting rights-of-way for power lines to attending annual meetings.¹⁴⁹

Successful cooperative governance required both a diligent board and an active, involved membership. Self-dealing by the board was a recurrent concern, and to block it, the REA took such steps as including in its model bylaws a requirement banning employment of directors or their relatives, prohibiting officers or directors from being elected officials or candidates for public office and keeping them from being “employed by or financially interested in private utilities and in equipment or appliance firms.”¹⁵⁰ In its publicity material, the REA also emphasized the board’s responsibility to perform a “trust function on behalf of the entire membership,”¹⁵¹ and perhaps as an attempt to reinforce this responsibility, the Model Act called the board a “board of trustees,” not of directors.¹⁵²

The REA’s most striking efforts to improve governance, however, lay in its attempts to mobilize cooperatives’ members. In the REA’s eyes, and certainly in its pronouncements, cooperatives were “democratic” institutions and required an active membership to succeed. There were, to be sure, some practical reasons for the REA to emphasize member involvement. Electric cooperatives’ success depended on a broad customer base consuming significant amounts of electricity, so a membership enthusiastic about the cooperative would likely improve its bottom line. Also, the fight between private and public power continued throughout the 1930s, with accusations lobbed of cooperatives promoting socialistic “government” power. To the extent that a cooperative appeared a local and democratic institution, such attacks would fail. Yet these do not fully explain the REA’s insistence that a successful cooperative required an active membership. Again and again the REA’s internal and external documents spoke of the cooperative as a “democratic institution” and discussed the role the membership needed to play in its operations. It warned in its 1939 annual report that, while a cooperative is democratically controlled, “[w]hether it remains democratic in fact depends upon whether the members actually exercise the rights they possess. For an electric cooperative, as for any other democratic institution, eternal vigilance is the price of liberty.”¹⁵³ Lurking in such language is the

149. KLINE, *supra* note 48, at 154.

150. MULLER, *supra* note 120, at 74.

151. Udo Rall, *Cooperation—How it Works*, RURAL ELECTRIFICATION NEWS, March 1939, at 3.

152. See DRAFT OF RURAL ELEC. COOP. ACT § 7 (RURAL ELECTRIFICATION ADMIN. 1939).

153. RURAL ELECTRIFICATION ADMIN., 1939 ANNUAL REPORT 64 (1940) [hereinafter 1939 REA REPORT].

suggestion that the cooperative would provide not only cheap power but also a guard against the era's totalitarian threats.

Hence arose the REA's repeated efforts to get members to become involved in their cooperatives. The Model Act, for instance, emphasized the importance of membership, by providing that officers and trustees had to be members of the cooperative, and provided members greater control over the cooperative than shareholders had over business corporations, by giving them the power to submit apparently binding propositions to the membership.¹⁵⁴ In a cooperative organized under the Model Act, 10% of members could submit "any proposition" to the membership without board approval to accomplish "consolidation, merger or . . . any other end strongly desired by members."¹⁵⁵

The REA also tried exhortation. In 1939 it issued *A Guide for Members of REA Cooperatives*,¹⁵⁶ written in straightforward language and intended to teach members about the cooperative's role as a democratic institution and their role within it. While "[c]ooperation splendidly demonstrates the adaptability of old-fashioned democracy to new-fashioned problems," the brochure stated that cooperatives' success requires the "constant, active participation of a well-informed and loyal membership."¹⁵⁷ Cooperatives failed when members did not participate. "Perhaps they picked a poor board of directors who hired an incompetent manager. Perhaps they allowed a small group of people to control and run the business as they pleased, and to feather their own nest."¹⁵⁸

Where and how members should exercise their rights also concerned the REA, which focused on the cooperative's annual meeting. Such meetings, the REA claimed, were less shareholder meetings than town halls; as one annual report put it, for many cooperatives "annual meeting day is election day, old home day and Fourth of July rolled into one."¹⁵⁹ Attendance was essential: "Projects become successful cooperatives when the members turn out in a body for the annual meeting, express their views freely, and vote."¹⁶⁰ *Rural Electrification News* carried more than one story emphasizing the importance of the annual meeting in the life of the cooperative as an event where members could not only hear from managers and learn about the cooperative's operations but also socialize, celebrate the cooperative, and incidentally see presentations about new electrical appli-

154. See DRAFT OF RURAL ELEC. COOP. ACT § 8.

155. *Id.* § 17 cmt.

156. REA MEMBER GUIDE, *supra* note 141.

157. *Id.* at 6-7.

158. *Id.* at 17.

159. 1939 REA REPORT, *supra* note 153, at 65.

160. *Id.* at 66.

ances for farm- and housework.¹⁶¹ Part of the meeting's function was to remind members that they were indeed owners of the cooperatives, and not just its customers, especially in regions where cooperatives were novel and members "understood little about the management of their co-op's affairs or the necessity of keeping a watchful eye over their own enterprise."¹⁶²

An even more radical attempt to encourage member participation was the REA's push for active participation by women. Women had long been seen as one of the major beneficiaries of rural electrification, which promised to free them from the backbreaking labor involved in such everyday tasks as ironing and washing clothes, drawing water, and preparing food.¹⁶³ Senator Norris, who grew up on a farm, spoke eloquently of "the grim drudgery and grind which had been the common lot of eight generations of farm women," and described "thousands of women . . . growing old prematurely" on farms without power.¹⁶⁴ REA director John Carmody claimed that "[i]n many cases the homemakers will derive more benefit from the use of electricity than the men."¹⁶⁵ That being the case, women were well positioned both to appreciate power's benefits and to serve as stewards of the cooperatives providing it. The REA's Model Act allowed, and REA publicity encouraged, husbands and wives to hold a joint membership in the cooperative, sharing a vote.¹⁶⁶ While in other settings this could be seen as an attempt to give husbands control, the REA adopted it specifically to "permit . . . the election of women to [the] board of trustees,"¹⁶⁷ something also encouraged by REA administrators.¹⁶⁸ By 1940 it appeared to be REA policy (perhaps honored in the breach) that new cooperatives include women as directors.¹⁶⁹

Even the design of a cooperative's building was supposed to reflect the importance of active participation and its democratic nature. A cooperative's office, the REA stated in its 1939 annual report, should be arranged so as to encourage member involvement, and members entering it should not be "discouraged by a high counter which separates the visitor from the office staff, or a private office in which the manager is guarded against

161. See CHILDS, *supra* note 112, at 140 (explaining the annual meeting as a way to "build a sense of mutual responsibility"); *id.* at 65.

162. *Id.* at 123–24.

163. For an extraordinary account of the backbreaking work needed on a nonelectrified farm, see ROBERT A. CARO, I THE PATH TO POWER: THE YEARS OF LYNDON JOHNSON 502–15 (1982).

164. BROWN, *supra* note 61, at 20 (quoting GEORGE NORRIS, FIGHTING LIBERAL 318 (1945)).

165. *Directors Are Trustees, Says Carmody; Women Needed on Every Board*, RURAL ELECTRIFICATION NEWS, Sept. 1938, at 23 [hereinafter *Directors Are Trustees*].

166. See DRAFT OF RURAL ELEC. COOP. ACT § 9(e) (RURAL ELECTRIFICATION ADMIN. 1939).

167. *Id.* at 4, introductory cmt.

168. See *Directors Are Trustees, supra* note 165, at 23 ("As a matter of fact, every REA board should have women on it as active members.").

169. Compare KLINE, *supra* note 48, at 174 (reporting an REA requirement for women directors), with MULLER, *supra* note 120, at 75 (reporting women on boards was rare).

visitors. Cooperative headquarters should serve as a rallying point for members . . . to increase member participation in cooperative business.”¹⁷⁰ In the Tennessee Valley, TVA architects supplied plans for buildings intended to reflect this spirit, even after the REA had taken over the task of organizing electric cooperatives from the older agency.¹⁷¹

Along with encouraging member activism, the REA also tried to block the ability of small groups to gain power over cooperatives. The election of women to boards, along with the Model Act’s provision concerning a cooperative’s board of trustees, was a clear attempt to diversify a board’s membership. While the Model Act required a board to have at least five members, the cooperative’s bylaws could set a larger number, which the Model Act’s Comment explained was included to prevent “undue control by small groups, particularly by Boards of Trustees.”¹⁷² Another area where abuses could occur was in proxy voting by members; one observer reported that the REA believed proxies had been “abused enough to cause REA to discourage it.”¹⁷³ The Model Act set a default rule banning the use of proxies. The bylaws could change this a bit, but the Model Act absolutely forbade any person from voting “as proxy for more than three (3) members at any meeting of the members.”¹⁷⁴ The hope clearly was that this would lead more members to attend annual meetings, though it also blocked attempts by management to obtain and vote proxies for uninformed members.

These provisions hint that governance problems were more systemic than the REA was willing to admit, and REA documents support this. Historian Ronald Kline has recorded repeated failings at cooperatives during the REA’s first decade.¹⁷⁵ In 1937, one REA staffer claimed that not a single cooperative in “Indiana, Iowa, and Ohio . . . had called an annual meeting to elect a board of directors.”¹⁷⁶ “The first complaint on a laundry list of co-op problems” prepared by two REA staffers in 1939 was of “self-perpetuation of virtually self-appointed boards of directors.”¹⁷⁷ The problem of one person dominating a cooperative was a recurrent one, a famous example being then-Congressman Lyndon Johnson’s domination of the

170. 1939 REA REPORT, *supra* note 153, at 67.

171. *See id.* For a discussion on the supplanting of TVA by the REA, see SARAH PHILLIPS, THIS LAND, THIS NATION: CONSERVATION, RURAL AMERICA, AND THE NEW DEAL 100 (2007); 1939 REA REPORT, *supra* note 153, at 67–68.

172. DRAFT OF RURAL ELEC. COOP. ACT § 9 cmt. (RURAL ELECTRIFICATION ADMIN. 1939).

173. MULLER, *supra* note 120, at 74.

174. DRAFT OF RURAL ELEC. COOP. ACT § 8(g).

175. KLINE, *supra* note 48, at 168–73. Kline makes the good point that these were governance failings in the eyes of REA personnel; it is more difficult to gauge whether cooperative members similarly worried about them.

176. *Id.* at 168.

177. *Id.*

Pedernales Electric Cooperative in Texas.¹⁷⁸ At other cooperatives, self-dealing was the problem, with board members being employed by the cooperative, employing relatives, owning businesses that would benefit from the cooperative (notably appliance stores), or stealing from the cooperative.¹⁷⁹

The flipside to managerial dominance and malfeasance was member apathy. Despite the efforts discussed above to boost participation and REA publicity that lauded the “resurgent democracy of cooperatives,” member involvement was often lackluster.¹⁸⁰ Some annual meetings indeed became popular social affairs, as the REA hoped they would, but attendance figures at most meetings tended to hover from 20% to 30%, and even lower at some meetings.¹⁸¹ REA documents through the 1930s and 1940s repeatedly complained about lack of member involvement.¹⁸² Some of this was probably rational apathy. Members had initially joined the cooperative to receive electric power, and once the lines reached their farms, that goal was met. From then on, many treated the cooperative as just another utility from which they purchased a service. Arrangements were also such that members had little sense of ownership in the cooperative. The cooperatives were funded with government loans, not with member investments, and as one cooperative manager from Wisconsin reported, “‘directors and members . . . are beginning to view the projects as ‘government’ owned instead of cooperatively owned’ and thus were losing the ‘cooperative enthusiasm’ they originally had for the projects.”¹⁸³ One poll of cooperative members, taken in Texas in the late 1940s, found that two-thirds of members did not realize they owned the cooperative.¹⁸⁴

Members certainly saw little direct economic gain from their membership (however much they benefited from receiving power). In the typical consumer cooperative, members received patronage refunds (also called patronage dividends) based on their use of the cooperative’s services.¹⁸⁵ RECs, however, almost never paid such refunds in this period. Any surplus generated by the operation was put toward paying off its REA loan, and even after the loan was paid off, the REA put pressure on co-ops to devote

178. *Id.* at 170. Johnson’s political clout was such that the REA was unable to do anything about this. *See id.*

179. *See id.* at 170–71.

180. NYE, *supra* note 55, at 334.

181. MULLER, *supra* note 120, at 80; *see also* KLINE, *supra* note 48, at 173.

182. *See* KLINE, *supra* note 48, at 173.

183. *Id.*

184. *Id.* at 222.

185. JERRY VOORHIS, AMERICAN COOPERATIVES 19, 129–30 (1961); *see also* DRAFT OF RURAL ELEC. COOP. ACT § 20 (RURAL ELECTRIFICATION ADMIN. 1939).

funds to lowering electrical rates rather than paying rebates to members.¹⁸⁶

Evidence suggests that the problem of apathetic membership and board malfeasance was never solved. In the 1950s, REA staffers reported that “the old problems of autocratic and self-perpetuating boards of directors” had reappeared in several states, while also complaining that “in far too many of our co-op borrowers, member apathy appears to be still rather widespread.”¹⁸⁷ A decade later, Jerry Voorhis, executive director of the Co-operative League, writing in support of RECs, nonetheless admitted that while most “electrical cooperatives are strong organizations with loyal, proud memberships,” there were cooperatives where “the manager has worked himself into the position of a virtual dictator” and others where members “take electric service as a matter of course.”¹⁸⁸

This is not to say that members were utterly disconnected from the cooperatives. Clearly, there were cooperatives where members were active in governance. There were also areas in which it seems members treated their cooperatives differently than a customer would treat a typical utility. The most notable was the often-discussed postcard method for members to pay their utility bills. In most REA cooperatives, members read their own electric meters each month and mailed the results to the cooperative on a postcard, from which bills were calculated—a system that saved co-ops money but obviously relied on member honesty.¹⁸⁹ Members also appeared willing to provide the cooperative rights of way across farmland or to allow tree-cutting on their property, without compensation.¹⁹⁰ But when it came to governance, according to one observer, members were willing to act only when things were seriously amiss, “but not to undertake positive action” when things appeared to be working well.¹⁹¹

For all their problems, RECs were successful in electrifying the countryside. By the end of the 1930s, 33% of all farms had access to power, compared to 13% in 1930.¹⁹² After a halt in construction during World War II, building resumed, and by 1956, 96% of farms had power, effectively achieving the goal of rural electrification.¹⁹³ But governance problems appeared unresolved, and in the postwar era, the REA faced a new challenge

186. See MULLER, *supra* note 120, at 71; TWENTIETH CENTURY FUND POWER COMM., *supra* note 78, at 472.

187. KLINE, *supra* note 48, at 224.

188. VOORHIS, *supra* note 185, at 59.

189. See, e.g., Rall, *supra* note 113, at 221; see also TWENTIETH CENTURY FUND POWER COMM., *supra* note 78, at 466.

190. See TWENTIETH CENTURY FUND POWER COMM., *supra* note 78, at 466.

191. MULLER, *supra* note 120, at 80.

192. KLINE, *supra* note 48, at 287 tbl.A.5.

193. *Id.* at 219. In 1959, REA cooperatives served 70% of the nation’s farms. *Id.* at 220.

to its organization of cooperatives as private utilities attempted to purchase several RECs.¹⁹⁴

In 1946 and 1947, an electric cooperative in Oregon and another in Idaho were acquired by local utility companies.¹⁹⁵ According to journalist Marquis Childs, such attempts were the product of governance failures: “[W]here the utilities sought to buy out the co-op, the relationship between members and management was indifferent or poor.”¹⁹⁶ In a cooperative whose members were uninvolved in the co-op and unclear about their role in it, “[t]his was an invitation to the utility to send in skillful public-relations men who could further confuse and divide an uncertain membership.”¹⁹⁷

After these two sales, the REA set out to block any more in what would become a recurrent pattern of REA and cooperative hostility to takeovers. In 1948, the private Appalachian Power Company proposed to purchase the Craig-Botetourt Electric Cooperative in southern Virginia, yet another cooperative with a record of poor management and uninvolved members: “The contact between manager and membership was virtually nonexistent The office management was inefficient Apathy and resentment had spread not only among the membership but even in the board of directors.”¹⁹⁸ The REA responded by “sen[d]ing some of its crack field men to try to straighten out [the cooperative] and to protect the government investment there.”¹⁹⁹ At the annual meeting where Appalachian’s offer would be considered by the membership, a fiery speech was offered by the head of the electric cooperatives’ national lobbying organization, the National Rural Electric Cooperative Association (NRECA), organized in 1942, who urged the farmers not to “sell out to Wall Street interests,” and the power company’s offer went down to defeat.²⁰⁰ After this and similar situations where local power companies tried to purchase cooperatives, the REA beefed up its efforts at “educating” members of their role in the cooperative, and the NRECA also became involved in such campaigns.²⁰¹

Another step the REA took to forestall such sales was to adopt a “capi-

194. Before World War II, there appears to have been only one instance of a cooperative selling out: in 1937, the Carolina Power & Light Company purchased a cooperative still on the drawing boards. CHILDS, *supra* note 112, at 82.

195. KLINE, *supra* note 48, at 221.

196. CHILDS, *supra* note 112, at 83.

197. *Id.*

198. *Id.* at 84.

199. *Id.* at 85.

200. *Id.* at 86. On the NRECA, see KLINE, *supra* note 48, at 217–18.

201. CHILDS, *supra* note 112, at 89–90. One sign that sales of cooperatives were an ongoing concern to the REA was that, when the agency began lending to telephone cooperatives, they required an agreement that borrowers could not sell their systems without REA approval. KLINE, *supra* note 48, at 234.

tal credits program,” which required cooperatives to “record the capital each member paid into the cooperative as part of their monthly electric bill.”²⁰² As one REA historian explained it, “[i]n large part this was another attempt to forestall co-ops selling out to power companies by educating members that they received their electricity from a consumer-owned cooperative, not a power company.”²⁰³ By 1952, most REA cooperatives had adopted the plan, with two even giving members small refunds of their capital credits that year.²⁰⁴

By the early 1950s, the completion of rural electrification led the agency to “essentially stop[] organizing co-ops . . . and eliminate[] many of them through consolidations.”²⁰⁵ Debates have been waged since the REA’s founding over whether its loans effectively subsidized rural electrification. But there can be little doubt that it succeeded at bringing power to the countryside,²⁰⁶ and almost all REA loans were eventually repaid, with a default rate of less than 1%.²⁰⁷ After the REA ceased organizing electric cooperatives, it continued loans to them to improve infrastructure and, beginning in 1949, added a new goal when it began making loans to expand rural telephone service. This was a less radical move than the push for electrification, as loans were made to existing private telephone companies as well as electric and telephone cooperatives, but it still involved significant effort; within a decade, the REA had loaned almost \$700 million to 705 borrowers in forty-five states.²⁰⁸ In 1994, a reorganization renamed the REA as the Rural Utilities Service (RUS), which continues to provide support for infrastructure and infrastructure improvement in water and waste treatment, electricity supply, and telecommunications.²⁰⁹

Now, decades after rural electrification’s victory, the mission of most RECs is much the same as it was in the 1930s: to distribute electricity to rural consumers. Today, almost 900 rural electric cooperatives are in operation in rural America, with 833 being of the distribution variety and sixty-two being generation and transmission (G&T) cooperatives, established to

202. KLINE, *supra* note 48, at 226.

203. *Id.*

204. *Id.*

205. *Id.* at 220.

206. *See, e.g.*, Kitchens & Fishback, *supra* note 130, at 1161 (“The ex-ante subsidy from the [REA] low-interest loans was large, but after the program was completed, nearly all of the loans were fully repaid, and the ultimate cost to the taxpayer was relatively low.”).

207. Laurence J. Malone, *Rural Electrification Administration*, EH.NET, <https://eh.net/encyclopedia/rural-electrification-administration/> (last visited Aug. 30, 2018).

208. RURAL ELECTRIFICATION ADMIN., TWENTY FIVE YEARS OF PROGRESS: RURAL TELEPHONE SERVICE 29 (1974); *see also* KLINE, *supra* note 48, at 227–40; Persons, *supra* note 103, at 86–87.

209. *See Rural Utilities Service*, USDA RURAL DEV., www.rd.usda.gov/about-rd/agencies/rural-utilities-service (last visited Aug. 30, 2018).

provide wholesale power where it cannot be purchased.²¹⁰ Rural “cooperative utilities serve more than 42 million people in 47 states, maintain 42 percent of the nation’s distribution lines, and deliver 11 percent of all electricity.”²¹¹

Unfortunately, also surviving are the corporate governance problems that have plagued RECs since their earliest decades. As one observer put it, in a passage worth quoting at length, anecdotal evidence of abuse by cooperative managers and apathy of co-op members still abounds:

An Alabama co-op failed to hold elections for board members for 38 years. A suburban Atlanta co-op turned over its entire operation to a for-profit subsidiary that diversified into ‘pest control, mortgages, consulting, a customer call center, staffing, security systems, natural gas and another co-op’ A suburban Fort Worth co-op borrowed a billion dollars to buy a golf course, Westin hotel, and shopping mall—then declared bankruptcy. Another Texas co-op has paid its board chairman almost \$200,000 a year despite his ignorance of basic co-op information.

As embarrassing as these examples are, co-ops have even greater potential for mismanagement and self-dealing Employees can be paid while doing no work. Managers can easily become more concerned with providing benefits to insiders than to ratepayers, especially if rate-payers are not looking.²¹²

In Part III, we analyze these problems more systematically and empirically, and propose solutions to them.

III. THE CORPORATE GOVERNANCE OF RURAL ELECTRIC CO-OPS: THE CASE FOR OPENING UP THE M&A MARKET

The governance of RECs is specially allocated among the members, the board of directors, and the officers.²¹³ Their structures are substantially the same in most states, which allows RECs to organize under electric cooperative acts descending from the model acts.²¹⁴ In electric cooperatives,

210. Nat’l Rural Elec. Coop. Ass’n, *Co-op 101: Electric Co-op Facts and Figures*, AM.’S ELECTRIC COOPERATIVES (Mar. 9, 2018), <https://www.electric.coop/electric-co-op-facts-figures-march-2018/>.

211. Kitchens & Fishback, *supra* note 130, at 1162.

212. Cooper, *supra* note 13, at 341–42 (footnotes omitted).

213. Donald A. Frederick, *Co-ops 101: An Introduction to Cooperatives*, in USDA RURAL DEV. COOP. INFO. REP. 55, at 40 (1997), <https://www.rd.usda.gov/files/publications/CIR55.pdf>.

214. As discussed above, in the 1930s, the Public Works Administration and the REA propagated model acts that eventually systematized most states’ laws governing RECs. *See supra* text accompanying notes 124–26. In thirty states with 70% of NRECA voting members, RECs are organized under electric cooperative acts. *See* Tyrus H. Thompson, Deputy Gen. Counsel, Nat’l Rural Elec. Coop. Ass’n, Presentation at Independent Auditors Conference, *Complying with Electric Cooperative State Statutes*, slide 2 (July 12, 2017), https://portal.nrucfc.coop/content/dam/cfc_assets/public_tier/Public%20Images/meetings/iac2017/Complying_Electric_Cooperative_State_Statutes.pdf. For reasons ex-

the members are customers actively receiving electrical service and holding voting rights for all matters prescribed by the bylaws. Members must make investments in patronage equity, usually in the form of an initial membership fee, and a portion of each regular power payment goes towards patronage equity. Additionally, accumulated patronage equity can result when retained earnings and the aforementioned investments outpace patronage refund payments. Patronage equity can be further divided into allocated and unallocated patronage equity, dependent on whether the equity is assigned to any specific owner-member capital account. Allocated equity (i.e., equity attributed to a specific member) is generally considered refundable, whereas unallocated equity is considered permanent capital that remains as the cooperative's capital base. As such, patronage equity is considered a residual claim to cooperative assets in the event of liquidation. In this regard, members of an electric cooperative can be thought of as holding the same position in the REC as shareholders do in a corporation. As of January 2017, the NRECA reported that RECs have \$55 billion in equity, which works out to an average of \$2,894 per customer-member.²¹⁵

Each cooperative has a board of directors that has largely the same function as does a typical corporate board, with a couple of special restrictions unique to the cooperative structure.²¹⁶ First, all the directors in a cooperative must usually be owner-members. Second, cooperatives in many states have the option of dividing their operating territory into districts and electing directors by these representative districts. However, these districts all have the same election methods, conflict-of-interest rules, and other familiar corporate board restrictions. Lastly, the officers in a cooperative are elected or appointed by its board of directors to perform whatever functions deemed necessary to the firm's operations. They are not required to be service-receiving members and are subject to removal at any time the board determines such action would be in the cooperative's best interest.

As we discussed in Part II, RECs from the beginning have had weak corporate governance structures, and the corporate governance revolution of the past few decades has left them largely untouched.²¹⁷ Historically, the range of problems runs from managers hiring relatives to work at the co-op to excessive compensation and managerial entrenchment. Cooperatives fail

plained below, we have taken Tennessee as a case study for this Article, so many of the citations here are to Tennessee's Rural Electrification Act, but this Act resembles those of most other states.

215. See Nat'l Rural Elec. Coop. Ass'n, *supra* note 7. The average derives from the figure of \$55 billion in equity and 19 million REC members; figures at individual RECs may of course vary widely.

216. TENN. CODE ANN. §§ 65-25-107 to -108 (2015).

217. See generally Brian R. Cheffins, *The History of Corporate Governance*, in OXFORD HANDBOOK OF CORPORATE GOVERNANCE 46 (Mike Wright et al. eds., 2013); Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 359 (2016).

because of bad boards of directors and uninformed, passive members. Member apathy is rampant, and only a small fraction of members attend annual meetings to cast their votes to elect directors. All of these problems are endemic in the current structure of RECs and the legal rules that have been developed to protect them. Good corporate governance systems, in contrast, thrive on diligent boards of directors acting without conflicts of interest on a fully informed basis and subject to close monitoring by outside investors. In RECs, members are typically the only outside investors, and they have almost no incentive to become informed or to participate in cooperative activities.

With this background, here we explore one potential solution to the monitoring problem at RECs: creating an active market for corporate control for these rural power providers. The development of the market for corporate control could act as a needed stimulus to push cooperative boards and officers to maintain better governance structures and would give consumer-members good reasons to engage in active monitoring of them.

This alternative monitoring mechanism is needed to stop managerial self-perpetuation and instill market discipline at RECs. We argue that opening up the market for corporate control is necessary if cooperatives are going to continue to act solely as distributors in the electricity market. An active M&A market would substitute active outside investor monitoring for the current broken system that relies almost exclusively on member oversight. We begin by reviewing agency cost theory and how it spotlights the need for investor oversight.

*A. Ending the Separation of Ownership and Control: M&A Activity
May Cure Weak Member Monitoring*

The agency conflicts that arise from separation of ownership and management of a business entity have been the source of much academic inquiry over the past forty years.²¹⁸ Agency theory postulates that the firm's owners are principals and its managers are their agents, and suggests that firms should be governed to minimize the agency costs that arise when returns to the owners fall below that which could be earned if principals exercised direct control.²¹⁹ The agency cost problem arises when the objectives of the principal and agent conflict, and it is difficult for the principal to verify what the agent is actually doing. Owner monitoring can be a solution to the problem if the owners are informed and can take cost-effective monitoring actions. However, if the owner cannot confirm wheth-

218. For the seminal article on this topic, see Jensen & Meckling, *supra* note 2.

219. *See id.* at 308–10.

er the manager has behaved properly, the manager may take actions that are not in the best interest of the owner.

In RECs, members are dispersed and relatively powerless to effectively monitor cooperative managers and directors. The costs of active monitoring are high, and the benefits appear small, as no one member can accumulate a larger voting stake in the company. This weak monitoring leads to a distinct separation of ownership and control. Reducing agency costs in this situation requires, among other things, substituting an alternative monitoring mechanism, such as the market for corporate control, to discipline cooperative management and directors to operate the firm in the members' best interests.

Much agency theory research focuses on finding the most efficient governance contracts between the firm's members, management, and board, assuming that all of these actors are motivated by self-interest and risk aversion and that there may be conflicts among them arising out of their different goals.²²⁰ Some examples of organizational phenomena that can be affected include managerial compensation, acquisition strategies, board relationships, financing, and innovation.²²¹

We are particularly focused here on the market for corporate control because of its unique ability to operate as a monitoring mechanism powered by outside investors, whose financial incentives to create value increases at poorly run firms. As Henry Manne famously pointed out, poorly managed companies are likely to become takeover targets, and takeovers can act in a unique way to discipline badly performing managers.²²²

To begin, we note that agency cost problems appear to be plentiful throughout the electrical utility industry, notably in public utilities. In one of the only important in-depth analyses of ownership and control rights at electrical companies, involving public utilities in Italy, the authors documented the clear-cut existence of an agency conflict arising from separation of ownership (in citizens, abstractly conceived) and control (lodged in municipalities).²²³ In this setting, a lack of independence prevents the board of directors from providing a useful solution to these conflicts, suggesting the need for other governance mechanisms to protect the members. This Italian study drew on a case study analysis of ten local public utilities to make in-

220. See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301–25 (1983).

221. See Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605, 605–16 (1981); Edward J. Conlon & Judi McLean Parks, *Effects of Monitoring and Tradition on Compensation Arrangements: An Experiment with Principal-Agent Dyads*, 3 ACAD. MGMT. J. 603, 603–05 (1990).

222. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965).

223. See Andrea Calabrò, Mariateresa Torchia, & Francesco Ranalli, *Ownership and Control in Local Public Utilities: The Italian Case*, 17 J. MGMT. & GOVERNANCE 835, 835–62 (2013).

ferences regarding the “existence of controversial problems in the governance systems.”²²⁴ The authors selected ten of seventeen utilities listed in the Italian Stock Exchange in 2008, collecting and analyzing data from the following sources: annual reports, corporate governance codes, corporate statutes, candidate lists for boards of directors, service charters, and board members’ resumes. This setting bears both similarities and, to be sure, distinct differences to that of the member-owned RECs, which are our focus. Nonetheless, certain aspects are worth summarizing.

The authors conducted an in-depth qualitative multiple case study, an approach argued to be most suitable for addressing the research questions below and for generating theory in an area where little data previously existed.²²⁵ The research questions included the following:

- What are the main characteristics of governance in this setting?
- “Is it possible to identify[] potential conflicts of interest situations among” players?
- If so, “is it possible to prevent and mitigate such problems?”²²⁶

The conclusions from this study of ten utilities included that it was difficult to answer how independent the directors were and that there was a need for other governance mechanisms to make them accountable to citizens.²²⁷

In Italy, as in the United States, the limited presence of competition prevents the market from correcting inefficiencies at many utilities. The board of directors may reside in a black box that needs opening.²²⁸ This concern is heightened in light of a recent study suggesting that, following disappointment with privatization of public utilities in many nations, the customer-ownership model is more likely to expand in the future.²²⁹ The best solution would be direct involvement of citizen-members in the decision making process.²³⁰ Unfortunately, as our historical discussion of rural electrification in the United States shows, theory and practice too often part ways when it comes to democratic control and members’ responsibility for the management of service provision in cooperatives.²³¹ As discussed above and in Part II, poor governance issues in RECs include member apathy, with only a small fraction attending meetings where directors are

224. *Id.* at 836.

225. *See generally* R. K. YIN, *CASE STUDY RESEARCH: DESIGN AND METHODS* (5th ed. 2014).

226. *See* Calabrò et al., *supra* note 223, at 836.

227. *Id.* at 855–58.

228. *See id.* at 858.

229. *See* Pier Angelo Mori, *Customer Ownership of Public Utilities: New Wine in Old Bottles*, 2 J. ENTREPRENEURIAL & ORG. DIVERSITY 54–74 (2013).

230. *See* Victor Pestoff, *Towards a Paradigm of Democratic Participation: Citizen Participation and Co-Production of Personal Social Services in Sweden*, 80 ANNALS PUB. & COOPERATIVE ECON. 197, 197–224 (2009).

231. *See supra* Subpart II.D.

elected; excessive compensation and entrenchment for managers; and the hiring of relatives to positions in the cooperative.

Hence, we turn to the market for corporate control as an alternative mechanism to discipline managers at RECs. The logical takeover and merger partners for most RECs are either other cooperatives or utilities privately owned by shareholders. Of these, the investor-owned firms are likely to be more efficient because they are more responsive to market forces.²³²

B. Are RECs Attractive Takeover Targets?

There appears to be great potential for M&A activity in the REC sector. “According to the NRECA, mergers among the co-ops that are uneconomically small could save customers at least \$220 each per year, resulting in huge savings for customers: this amount is roughly the equivalent of two free months of electricity.”²³³ We begin by pointing out that there has been some merger activity in recent years *between* RECs that resulted in greater economic efficiencies. For example, in the 2007 merger of Oliver Mercer Electric Cooperative and West Plains Cooperative, both located in North Dakota, it was estimated that the combination would save customer-members around \$5 million over the next ten years.²³⁴ In another case, the 2008 merger between two North Carolina RECs, Carteret-Craven Electric Cooperative and Harkers Island Electric Membership Cooperative, resulted in significant rate reductions for Harkers Island members (though little benefit for members of Carteret-Craven).²³⁵ There are also older examples of RECs and municipal utility districts acquiring other utilities to expand their service areas, particularly in the Pacific Northwest, with apparent success.²³⁶ So there appears to have been some economically beneficial activity in the M&A area involving combinations of RECs.

While there have been instances of investor-owned utilities attempting

232. See Herman K. Trabish, *IOU, Co-op or Muni? Experts Debate the Creation of Public Utilities*, UTIL. DIVE (Sept. 16, 2015), <https://www.utilitydive.com/news/iou-co-op-or-muni-experts-debate-the-creation-of-public-utilities/405511/>.

233. Cooper, *supra* note 13, at 364.

234. Lauren Donovan, *Consolidated Co-op Ok'd*, BISMARCK TRIB. (Dec. 7, 2007), https://bismarcktribune.com/news/local/consolidated-co-op-ok-d/article_bd3e40fb-272b-539c-9586-f88b727283be.html.

235. See Cooper, *supra* note 13, at 371 n.241.

236. See, e.g., Andrew Creasey, *Hermiston Shows City Utility District Can Be Done*, HERALD & NEWS (May 25, 2013), https://www.heraldandnews.com/members/news/frontpage/hermiston-shows-city-utility-district-can-be-done/article_445efe16-c4ef-11e2-9b6b-001a4bcf887a.html; *History of EPUD*, EMERALD PEOPLE'S UTIL. DISTRICT, <https://www.epud.org/about/history-of-epud/> (last visited Sept. 1, 2017); *Oregon Trail Electric Buys CP National*, L.A. TIMES (Oct. 7, 1988), http://articles.latimes.com/1988-10-07/business/fi-3496_1_oregon-trail-electric; *PUD History*, COLUMBIA RIVER PEOPLE'S UTIL. DISTRICT, <https://www.crpud.net/my-pud/about-puds-public-power/pud-history/> (last visited Sept. 1, 2017).

to take over RECs, those takeovers faced fierce political opposition that stymied any move toward a vigorous market for corporate control. As discussed in Part II, takeover attempts in the 1940s were met with lobbying campaigns organized by the REA and the NRECA.²³⁷ While takeovers were occasionally attempted, success was rare; one journalist found that up to the 1980s, only twelve takeover attempts had succeeded, the last being in 1972.²³⁸

Beginning in the 1980s, however, some investor-owned utilities, apparently inspired by the decade's takeover boom, looked to RECs as possible takeover targets. The NRECA, acting on behalf of cooperatives, responded swiftly. Its board adopted a resolution stating that takeovers "would jeopardize the existence of rural electric systems throughout the country,"²³⁹ funded a "war chest" for co-ops needing aid in fending off takeover attempts, and hired at least one full-time employee devoted to "combating takeover attempts at the ground level."²⁴⁰ While a few proposed takeovers were approved by members, most failed, as over the next decade "co-ops thwarted 105 takeover attempts and territorial disputes using a fund coordinated by NRECA" and the National Rural Electric Cooperative Financing Corporation.²⁴¹ As one author reported in a survey of 510 member systems, "326 indicated a willingness to contribute 5 percent of their patronage capital" to the antitakeover fund, with "[m]ost . . . respondents agree[ing] that establishing the fund was an appropriate rural electric objective."²⁴² This flurry of activity appears to have died out, however, and by the early twenty-first century one observer noted that "conventional wisdom held that . . . acquisitions [of RECs by investor-owned firms] were either impossible or not worth the trouble."²⁴³

Given the present absence of hostile takeovers of RECs, we ask a hypothetical question: if the legal barriers to such activity disappeared, would there be RECs that would be desirable takeover candidates? Identifying such targets is tricky without access to their internal books and records;

237. See *supra* text accompanying notes 198–204.

238. The last takeover had been by Mississippi Power & Light Company of Capital Electric Power Association in Jackson, Mississippi. Frank Gallant, *Investor-Owned Utilities on the Prowl*, RURAL ELECTRIC MAG. (Feb. 2, 2016), <https://www.cooperative.com/remagazine/articles/Pages/Investor-Owned-Utilities-on-the-Prowl.aspx>.

239. *Id.*

240. Frank Gallant, *Investor-Owned Utilities on the Prowl—Part 2*, RURAL ELECTRIC MAG. (Mar. 1, 2016), <https://www.cooperative.com/remagazine/articles/Pages/Investor-Owned-Utilities-on-the-Prowl-Part-2.aspx>.

241. Cooper, *supra* note 13, at 340 n.32.

242. *Id.*

243. Kevin T. Williams, *The Business Case for Co-Op Acquisitions*, FORTNIGHTLY MAG. (Jan. 2005), www.fortnightly.com/fortnightly/2005/01/business-case-co-op-acquisitions.

however, we can get some idea of the potential for such transactions based on publicly available data.

First, we note that two objectives are frequently offered by acquirers in M&As: (1) disciplining the target's management and (2) achieving synergies between the acquirer and the target.²⁴⁴ By combining the physical operation of two entities, a synergistic takeover is intended to generate gains from enhanced efficiency. In a disciplinary acquisition, gains may be earned without combining the two operations physically but rather from eliminating or curtailing the target managers' nonvalue maximizing operating behavior. In the disciplinary takeover, entities that are performing poorly are more likely to be targeted than entities that are performing more successfully. The nonvalue-maximizing behavior to be curtailed could include excessive compensation for managers, excessive perquisites, or overpayment for supplies or materials in related party transactions; or it might be argued that managers are incompetent at operating the target efficiently.²⁴⁵

In addition to these positive explanations for needed takeover activity, academic research has identified several less attractive factors that play a role.²⁴⁶ For example, high premiums for target stocks can result from hubris²⁴⁷ or from errors ultimately revealed by belated due diligence.²⁴⁸ Other explanations include the race to capture a leading position in an emerging product market or the possibility that managers are maximizing their own utility at the expense of the owners by engaging in empire building.²⁴⁹

Efforts to test these explanations have been inconclusive.²⁵⁰ For instance, an analysis of Spanish takeover targets between 1991 and 1997 found little support for the hypothesis that targets were less profitable or less highly valued than other entities in the same sector; however, most of the takeovers in this sample were friendly rather than hostile, suggesting that the acquisitions were more likely to be synergistic than disciplinary. This study found that firms with an imbalance between available resources

244. *See id.*

245. Kenneth J. Martin & John J. McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 J. FIN. 671, 671 n.1 (1991).

246. *See* Gregor Andrade et al., *New Evidence and Perspectives on Mergers*, 15 J. ECON. PERSP., Spring 2001, at 103, 104; Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP., Winter 1988, at 21, 24.

247. *See* Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197, 197 (1986).

248. *See generally* Matthew L. A. Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 ADMIN. SCI. Q. 103 (1997).

249. *See* Anju Seth, Kean P. Song & Richardson Pettit, *Synergy, Managerialism or Hubris? An Empirical Examination of Motives for Foreign Acquisitions of U.S. Firms*, 31 J. INT'L BUS. STUD. 387, 390-91 (2000).

250. *See, e.g.*, Krishna G. Palepu, *Predicting Takeover Targets, A Methodological and Empirical Analysis*, 8 J. ACCT. & ECON. 3 (1986).

and growth opportunities had a higher probability of being a target. One of the main conclusions of the study was the difficulty of finding a specific profile for the targets.²⁵¹

In general, a takeover target is attractive if it is believed that the entity will be managed more efficiently or effectively than in its previous state. For example, the merged entity may be able to eliminate unnecessary or duplicated costs, or the new management might be able to negotiate lower interest rates on debt.

Any analysis of electric utilities as potential takeover targets needs to consider at least six factors. First, how much cash is the firm carrying as part of its current assets? Current assets are defined under generally accepted accounting principles (GAAP) as cash or other assets that a firm expects to sell, consume, or convert to cash within a year or within its operating cycle, whichever is longer. Under U.S. GAAP, these current assets are listed in an entity's balance sheet in order of liquidity, with cash generally listed first as the most liquid asset. (For RECs, however, current assets are typically listed *after* plant assets and long-term investments.²⁵²) Well-managed investor-owned companies often have a target level of cash. Holding too much cash can indicate that funds could either be invested to generate additional income or returned to owners. On the other hand, holding a small amount of cash may suggest an inability to take advantage of opportunities that arise without costly borrowing.

Second, is the target distributing the excess of receipts over costs and expenses to its members? Cooperative members have in recent years complained, and even sued, about lack of distribution of capital credits.²⁵³ In our examination of the tax returns of over twenty-five randomly selected RECs for the year 2015, discussed further below, nearly 40% showed no return of profits (revenues minus expenses) to their owner-members, while investor-owned electric utilities routinely paid dividends to their owners.

251. See Nuria Alcalde & Manuel Espitia, *The Characteristics of Takeover Targets: The Spanish Experience 1991–1997*, 7 J. MGMT. & GOVERNANCE 1, 1 (2003).

252. See VOLUNTEER ENERGY COOPERATIVE, ANNUAL REPORT 2014–2015, at 5 (2015), <https://d2veoet8kyyfj.cloudfront.net/wp-content/uploads/2016/01/VECannrep2014-15.pdf> (showing Volunteer's cash is combined with temporary cash investments to total \$29,832,083.00, which constitutes over 50% of its current assets).

253. In recent years, at least fourteen class action suits have been filed by cooperative members alleging that their RECs did not refund capital credits. See James A. Orr & Thomas M. Byrne, *Legal Alert: Litigation Update on 14 Patronage Capital Cases in Eight States*, EVERSHEDES SUTHERLAND (Aug. 28, 2013), <https://us.eversheds-sutherland.com/NewsCommentary/Legal-Alerts/152035/Legal-Alert-Litigation-Update-on-14-Patronage-Capital-Cases-in-Eight-States>. Several of the suits allege that RECs are required by their state laws to refund those credits, claims which courts have so far rejected. See *Caver v. Cent. Ala. Elec. Coop.*, 845 F.3d 1135, 1148 (11th Cir. 2017) (finding Alabama law does not require an REC to distribute "excess revenues" to members in cast); *Simmons v. W. Fla. Elec. Coop. Ass'n*, No. 5:15cv321-RH/GRJ, 2017 WL 901102, at *2 (N.D. Fla. Mar. 7, 2017) (finding Florida law does not require an REC to refund excess revenues to members if the members vote to dispense with the requirement to distribute, which may be done by adopting bylaws).

Some data on both groups are presented in Table 1. This prompts a question regarding RECs: Why? Perhaps they are reluctant to set a precedent by returning profits and creating an expectation for yearly returns that they might be unable to satisfy in the future. As discussed below, it may also be that, for some cooperatives, contracts with power generators forbid such distributions.²⁵⁴ This raises another question: do the RECs instead find ways to spend the funds that are inefficient or less than optimal for the long-run benefit of the company and their members (e.g., excessive bonuses to managers)?

Third, if the cash is not being distributed to the members, how is it being spent? What is the firm doing with the excess of earnings over costs and expenses? This should be shown in a statement of cash flows, if available. For example, is the cash being spent on needed improvements or instead being retained unnecessarily? Without access to an entity's internal books and records, one cannot answer these questions definitively; however, a fair amount of information regarding cash outlays can be obtained from a statement of cash flows, when available. This financial statement presents information about all inflows and outflows of cash in three categories: operating activities, investing activities, and financing activities. The investing section is particularly pertinent in addressing these questions, as it details any expenditures aimed at investments in the physical plant (or intangible assets) with the goal of generating a positive return. Unfortunately, a statement of cash flows was unavailable in the financial statements we examined for RECs.

Fourth, are there indications that managers are being compensated more than executives at comparable utilities that are organized differently? One of the concerns related to the governance issues described in previous sections is the possibility that managers will pay bonuses or excessive compensation to themselves rather than distribute funds to owner-members. For publicly traded investor-owned entities, the Securities and Exchange Commission (SEC) requires disclosure of compensation to the chief executive officer (CEO), chief financial officer (CFO), and three other top executives.²⁵⁵ Public companies are also required to provide a Compensation Discussion & Analysis (CDA) providing a narrative discussion of "all material elements of the company's executive compensation programs."²⁵⁶ In perusing the tax returns of RECs in our example, all publicly available due to the RECs' tax-exempt status, we found most used similar language to

254. See *infra* Subpart III.C (discussing limits TVA may place on cooperatives purchasing power from it).

255. U.S. Sec. & Exch. Comm'n, *Fast Answers: Executive Compensation*, SEC.GOV, <https://www.sec.gov/fast-answers/answers-execomphm.html> (last visited Sept. 2, 2018).

256. *Id.*

address questions about compensation and governance.²⁵⁷ For example, Chickasaw Electric Cooperative stated in 2015:

Each year before the annual meeting all board members and key employees are required to sign a conflict of interest statement.

A survey is received each year . . . detailing comparative compensations per state, region, and nation. The manager recommends salary plans for the cooperative. This plan is modified or approved by the Board[.] The Board decides the increase amount and this is documented in the Board minutes.

All such documents are available at our office for review. Copies can be obtained by paying costs.²⁵⁸

Caney Fork Electric Cooperative disclosures (from 2012) are similar:

Financial information is distributed annually to members through an Industry Publication[.] All documents, policies, and financial information required to be made public by IRC 6104 are available upon request.

The board of directors review the performance of management employees on an annual basis and determine the compensation for these employees for the coming year.

The board members are requested yearly to complete a conflict of interest and disclosure form.²⁵⁹

Baldwin County Electric Membership Corporation (in Alabama) stated in 2015 with respect to conflicts of interest:

Officer[s], directors or trustees, and key employees are required to notify management or the Board as potential conflicts arise[.] The corporation reviews all payments and each supervisor determines if a potential conflict should be considered.²⁶⁰

Whether conflicts of interest are treated seriously appears to be left almost entirely to the discretion of the company or its management.

Fifth, at what rate is patronage capital growing over time compared to that of well-run cooperatives or to retained earnings of investor-owned utilities? To assess the growth, one needs to examine the trend across a few

257. See *Nonprofit Explorer*, PROPUBLICA, <https://projects.propublica.org/nonprofits/> (last updated Mar. 14, 2018) (providing tax return information from Form 990 for organizations exempt from income tax under Section 501(c)(12)). RECs are exempt from taxation as a Section 501(c)(12) “mutual or cooperative electric company.” See W. G. Beecher, Note, *Is It Time to Revoke the Tax-Exempt Status of Rural Electric Cooperatives?*, 5 WASH. & LEE J. ENERGY CLIMATE & ENV’T 221, 228–29, 229 n.58 (2013) (quoting Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, 94 Stat. 3521).

258. Chickasaw Elec. Coop., *Form 990, Schedule O*, PROPUBLICA 1 (2015), <https://projects.propublica.org/nonprofits/organizations/620157827> (select the “IRS Filing” PDF for 2015).

259. Caney Fork Elec. Coop., *Form 990, Schedule O*, PROPUBLICA (2012), <https://projects.propublica.org/nonprofits/organizations/620148804> (select the “IRS Filing” PDF for 2013).

260. Baldwin Cty. Elec. Membership Corp., *Form 990, Schedule O*, PROPUBLICA (2015), <https://projects.propublica.org/nonprofits/organizations/630014658> (select the “IRS Filing” PDF for 2015).

years. In a subsequent analysis from one of the Tennessee RECs examined, we present data on net assets from 2007 to 2015.

Before discussing those data, we present some basic accounting terminology for those unfamiliar with financial statement analysis. “Net assets” are defined as assets minus liabilities. The balance sheet, or statement of financial position, equates assets to the sum of liabilities plus owners’ equity:

$$\text{Assets} = \text{Liabilities} + \text{Owners' Equity}.$$

Another way of viewing this basic accounting equation is that liabilities represent the claims of creditors to the assets of an entity, while owners’ equity represents the claims of the owners. If we subtract liabilities from both sides, we obtain a new equation:

$$\text{Assets} - \text{Liabilities} = \text{Owners' Equity}.$$

Therefore, “net assets” may be equated to the owners’ claims, or equity. Equity may also be referred to as owners’ capital (or patronage capital, in the case of RECs).

To assess the growth rate, simply take the increase from one year to the next and divide by the first year’s amount. For example, if patronage capital grows from \$50,000 in year 2016 to \$60,000 in year 2017, the growth rate would be 20% ($\$10,000 \div \$50,000 = 20\%$). A high growth rate is another indication that an entity is not distributing profits to its members.

In an investor-owned entity, retained earnings are reported separately from the capital invested by owners. Dividends, or distributions to owners, are typically shown as reductions in retained earnings. When a return to owners is made from their invested capital, it is referred to as a “liquidating” dividend. In examining the tax documents of a number of Tennessee RECs, we found no evidence of profit distributions²⁶¹ but occasional evidence of “refunds” of invested capital. For instance, Caney Fork Electric Cooperative shows an increase in net assets of \$13,240 from memberships received and a decrease of \$12,285 from memberships refunded in 2013.²⁶²

Finally, how does the net profit margin of a particular REC—as a percentage of owner’s equity, total assets, or total revenues—compare to that of a well-run REC or of an investor-owned entity? Typical measures of performance or financial strength include return on assets (ROA), return on equity (ROE), and profit margin (excess of revenues over expenses divided by revenues). The first two measures take the bottom line from the income

261. In Tennessee, the decision not to distribute any excess proceeds may be made by the supplier, TVA, rather than by the individual cooperatives. *See infra* text accompanying notes 295–97; *see also* *Shadow v. Volunteer Elec. Coop.*, 448 S.W.2d 416, 419 (Tenn. 1969).

262. *See* Caney Fork Elec. Coop., *Form 990, Schedule O*, PROPUBLICA (2013), <https://projects.propublica.org/nonprofits/organizations/620148804> (select the “IRS Filing” PDF for 2014).

statement (net income or net margin) and divide it by one of the main sub-totals on a balance sheet (either total assets or net assets—*assets – liabilities*). The third measure takes two numbers from the income statement: net margin and total revenues.

The first two measures (ROA and ROE) assume that a certain amount of investment should generate an economic return. For example, the rate of return of money invested in a savings account could be calculated as the interest earned divided by the amount deposited. ROA measures an entity's success in using its assets to generate a return independent of its financing. It differs from ROE in that ROA is unaffected by the proportion of debt-to-equity financing. Thus, the profit margin is sometimes adjusted by adding back the cost of debt in calculating ROA:

$$ROA = (\text{Net Income} + \text{Interest Expense}) \div \text{Total Assets}.$$

ROE measures the return to owners after subtracting the cost of debt financing along with operating expenses. Thus, the numerator requires no adjustment but simply takes the entity's net margin from its Statement of Revenue and Expenses (sometimes referred to as the Statement of Earnings or Statement of Income):

$$ROE = \text{Net Income} \div \text{Net Assets}.$$

The net margin encompasses all the expenses incurred to measure how much excess is generated for a dollar of revenue. These measures indicate how efficiently an entity is being operated.

Signs of inefficiency, or lower ratios for RECs compared to investor-owned utilities, could suggest that RECs might constitute attractive targets for takeover if some of the factors prohibiting takeover were removed. IRS Form 990 requires patronage dividends for cooperatives to be reported as an expense. This is in direct contrast to GAAP, which treat dividends as a reduction in capital. To calculate the dividend payout ratio (*dividends ÷ profit margin*) and to facilitate comparison to investor-owned entities, we added back the dividends paid by RECs, if any, to the profit margin. In other words, the profit margin used in the denominator reflects the entity's net margin before subtracting the dividend.²⁶³

263. Form 990, Part IX, line four includes dividends for RECs, and more details are supposed to be described on Schedule D, Part XIII, though these are sometimes omitted. See *Form 990*, IRS.GOV 10 (2017), <https://www.irs.gov/pub/irs-pdf/f990.pdf>. Terminology in Part XIII varies from “[p]atronage [c]apital [c]redits [a]llocated,” or “margins allocated to members,” or “patronage dividends paid.” See Alger Delta Elec. Coop., *Form 990, Schedule D*, ALGER DELTA ELEC. 5 (2016), https://algerdelta.com/sites/algerdelta.com/files/2016_Form_990.pdf (providing example terminology as used in Schedule D, Part XIII); Idaho Cty. Light & Power Coop. Ass'n, *Form 990, Schedule D*, FOUND. CTR. 5 (2013), http://990s.foundationcenter.org/990_pdf_archive/820/820129905/820129905_201312_990O.pdf (providing example terminology as used in Schedule D, Part XIII); *Form 990, Schedule D*, N.H. ELEC.

Using this framework, we can shed light on some of these questions by examining several selected financial ratios for electric cooperatives and investor-owned utilities that are shown in Table 1. The cooperatives are a random sample of RECs in Tennessee, the locus of our case study, and elsewhere; data on investor-owned utilities are industry averages. (It should be noted that one number, the “Payout Ratio” for Tennessee cooperatives, may be misleading, as their contracts with TVA may forbid these cooperatives from making such payouts.)

Table 1. Selected Ratios for Electric Co-ops and Investor-Owned Utilities²⁶⁴

Panel A: Tennessee Cooperatives	EBITDA/ Revenue	Net Margin	Debt/ Equity	Payout Ratio
Appalachian Electric Cooperative	11.49%	3.91%	74.65%	0%
Caney Fork Electric Cooperative, Inc.	7.61%	-0.90%	160.56%	0%
Chickasaw Electric Cooperative, Inc.	28.47%	6.60%	17.12%	0%
Volunteer Energy Cooperative	9.67%	3.02%	32.89%	0%
<i>Average</i>	14.31%	3.16%	71.31%	0%
Panel B: Other Electric Cooperatives	EBITDA/ Revenue	Net Margin	Debt/ Equity	Payout Ratio
Cheryland Electric Cooperative (MI)	18.25%	8.65%	133.53%	58.35%
Adams-Columbia Electric Cooperative (WI)	23.63%	6.36%	136.68%	90.67%
Iliamna Newhalen Nondalton Electric Cooperative, Inc. (AK)	42.80%	8.35%	129.39%	0%
Mid-Yellowstone Electric Cooperative, Inc. (MT)	20.27%	8.18%	158.37%	2.35%
Tishomingo County Electric Power Association (MS)	40.35%	21.12%	53.87%	0%
Washington Island Electric Cooperative, Inc. (WI)	20.94%	8.53%	86.84%	0%
Cherokee County Electric Cooperative Association (TX)	14.38%	5.63%	85.21%	0%
Northern Virginia Electric Cooperative (VA)	11.24%	5.81%	32.23%	25.96%
Spoon River Electric Cooperative, Inc. (IL)	20.57%	6.60%	108.65%	54.90%

COOP. 5 (2017), https://www.nhec.com/wp-content/uploads/2018/06/2017-Form-990_reduced.pdf (providing example terminology as used in Schedule D, Part XIII).

264. See *Nonprofit Explorer*, *supra* note 257 (providing tax information for entities in Panels A and B for 2015). EBITDA (in column 2) means “earnings before interest, tax, depreciation and amortization.”

Craig-Botetourt Electric Cooperative (VA)	11.83%	-3.19%	145.32%	-56.71%
Rural Electric Cooperative, Inc. (OK)	17.63%	9.20%	108.60%	97.11%
Sheridan Electric Cooperative, Inc. (MT)	39.64%	10.82%	243.99%	21.08%
Union Rural Electric Cooperative, Inc. (OH)	16.38%	8.87%	111.00%	100.21%
Alger Delta Cooperative Electric Association (MI)	27.56%	9.67%	191.41%	106.04%
Buckeye Rural Electric Cooperative, Inc. (OH)	19.50%	4.96%	167.49%	0%
Cumberland Valley Electric, Inc. (KY)	12.80%	4.24%	126.84%	100%
Fannin County Electric Cooperative, Inc. (TX)	15.87%	5.43%	90.05%	100%
Presque Isle Electric & Gas Cooperative (ME)	21.90%	8.82%	122.26%	46.40%
Rural Electric Convenience Cooperative Co. (IL)	15.09%	2.39%	220.05%	78.85%
Todd Wadena Electric Cooperative (MN)	22.78%	6.41%	133.01%	101.93%
Woodbury County Rural Electric Cooperative (IA)	22.76%	9.96%	81.08%	56.54%
East Kentucky Power Cooperative, Inc. (KY)	28.90%	5.52%	550.89%	0%
<i>Average, Adjusted</i> ²⁶⁵	22.05%	7.38%	146.22%	44.71%
<i>Average, Unadjusted</i>	18.59%	3.94%	146.22%	44.71%

265. For the adjusted average, we added back the dividend distribution in computing both EBITDA/Revenue and the Net Margin to facilitate comparison to investor-owned entities. The distributions to members are treated as an expense by RECs on Form 990, consistent with a view that the distribution reflects a refund of some portion of the amounts paid by members for purchasing electricity; however, GAAP treats these distributions as a reduction in Patronage Capital, and not in Net Margin. Adjusted ratios are presented for individual cooperatives in Table 1. It might be noted that the unadjusted ratios for EBITDA/Revenue and Net Margin would be even lower than those shown. For the last two columns, the alternative treatments of dividends have no effect on the ratios.

Panel C: Investor-owned Electric Utilities by Year ²⁶⁶	EBITDA/Revenue	Net Margin	Debt/Equity	Payout Ratio ²⁶⁷
2011	27.84%	8.33%	130%	125.6% (Q2, 2016)
2012	27.07%	6.26%	133%	113.8% (Q3, 2016)
2013	29.09%	7.80%	130%	163.0% (Q4, 2016)
2014	29.92%	8.61%	138%	144.3% (Q1, 2017)
2015	25.20%	8.70%	9%	125.4% (Q2, 2017)
2016	26.42%	9.69%	11%	110.6% ²⁶⁸ (Q3, 2017)
<i>Average</i>	27.59%	8.23%	91.83%	130.43%

We begin by comparing the financial strength ratios of the different electric cooperatives for which we were able to find public data. Panel A presents public information on four Tennessee electric cooperatives for the year 2015, while Panel B shows public data hand-collected from twenty-two RECs from other states taken from their tax filings for 2015.²⁶⁹ Panel C provides the values for investor-owned electric utilities for years 2011 through 2016.²⁷⁰ We can visually compare these values to illustrate several important points. First, if we compare the averages for the Tennessee electric cooperatives to the industry averages for electric utilities organized as investor-owned entities, we find that the electric cooperatives tend to have lower EBITDA margins (earnings before interest, taxes, and amortization), with the exception of Chickasaw Electric Cooperative.²⁷¹ Whether EBITDA or the net margin is the more appropriate measure of a firm's performance in a given period can be debated. The net margin incorporates all the expenses incurred by an entity, including such non-cash expenses as depreciation and amortization. Because these items are allocations of ex-

266. *Electric Utilities Industry Dividend: Dividend Information and Trends*, CSIMARKET, https://web.archive.org/web/20170626002309/https://csimarket.com/Industry/industry_dividends.php?id=1201 (last visited Sept. 27, 2018).

267. For the payout ratio, our data source reported dividends paid for each of the six most recent quarters. *Electric Utilities Industry Dividend: Dividend Information and Trends*, CSIMARKET, https://web.archive.org/web/20170626002309/https://csimarket.com/Industry/industry_dividends.php?id=1201 (last visited Sept. 27, 2018).

268. For the third quarter of 2017, the average payout ratio reflects only those companies who had reported as of December 13, 2017.

269. See *Nonprofit Explorer*, *supra* note 257 (providing tax information drawn from the entities' Form 990s in Panels A and B for 2015).

270. *Electric Utilities Industry Dividend: Dividend Information and Trends*, *supra* note 266.

271. We note that because of the variation in terminology used in the annual reports of cooperatives, drawing clear comparisons to other organizational forms from the data is somewhat problematic.

penditures made in a previous (or current) period but do not require a cash outlay, analysts often exclude them in their recommendations. The EBITDA measure excludes not only depreciation and amortization but also interest and taxes in order to take out the impact of financing and tax management on the performance measure.

As seen in Table 1, the average EBITDA ratio for the RECs examined was around 14% for Tennessee RECs and 22% for others (adjusted by adding back dividends).²⁷² In contrast, the EBITDA ratio for investor-owned electric utilities averaged nearly 28%.²⁷³ Similarly, the net margin for Tennessee RECs averaged around 3%, for other RECs around 7% adjusted or 4% unadjusted, and for investor-owned entities over 8%. At least two interpretations could be relevant here. Managers of electric cooperatives are likely to have less incentive to report to their member-owners that they are managing the entity efficiently, as their members do not expect distributions and often do not understand the financial reports. Because of the variation in terminology utilized in the financial statements, even seasoned accountants may have trouble disentangling the information. An alternative interpretation is that the RECs have deeper pockets due to a lack of competition in the geographic area. Thus, RECs might be enabled to spend or invest in ways that might not be allowed in investor-owned entities, ways that might be beneficial for managers but not for owners (e.g., salaries, bonuses, or executive perquisites, as discussed later in this section).

We recognize that reliance on accounting-based ratios does not replace due diligence in assessing takeover potential because, among other things, company objectives vary, numbers can be manipulated, ratios are a function of accounting method choices, and they reflect past rather than future performance. Further, we acknowledge that, due to differences in the missions of electric cooperatives and investor-owned utilities, lower profit margins are not necessarily indicative of operating inefficiencies. These ratios are, nonetheless, a potentially useful starting point.

Based on an examination of the four Tennessee RECs' average data, for example, one might conclude that three of the four are not being run efficiently compared to the investor-owned entities and that the profits of these three firms could be improved. In contrast, the Chickasaw cooperative has a more comfortable profit margin and a very low debt-to-equity

272. For the adjusted average, we added back the dividend distribution in computing EBITDA/Revenue and the Net Margin to facilitate comparison to investor-owned entities. The distributions to members are treated as an expense by RECs on Form 990, consistent with a view that the distribution reflects a refund of some portion of the amounts paid by members for purchasing electricity; however, GAAP treats these distributions as a reduction in Patronage Capital and not in Net Margin. The adjusted average was lower at 18%. (For Tennessee, the average is not adjusted because the RECs paid no dividends.) See *supra* Table 1, Panels A & B.

273. See *supra* Table 1, Panel C.

ratio. The latter measure is consistent with profits being retained in the form of equity rather than being distributed to members. Both Chickasaw and Volunteer Energy have a ratio of accumulated (undistributed) income to total assets in excess of 75%.²⁷⁴ While not necessarily indicative of a problem, a high level of accumulated income (equity) relative to debt or assets raises two questions: Why doesn't the REC distribute some of its profits to its member-owners?²⁷⁵ If such an entity were merged, would owners benefit?

Whereas investor-owned utilities generally pay dividends to their investors on a regular basis, electric cooperatives often distribute their members' share of accumulated profits erratically or not at all.²⁷⁶ An analysis by Jeffrey Royer suggests that most rural electric cooperatives could expand their capital credits retirement significantly without weakening their financial condition.²⁷⁷ In fact, they might actually improve their ROE, defined earlier in this Article. Recall that ROE reflects an entity's return on equity, measured as its profit margin or net income divided by its capital or net assets. When capital is returned to members, the denominator decreases and the ratio or return on equity increases due to increased use of financial leverage in the overall capital structure. As Royer points out, the ongoing effect is improved ability to retire capital in a timely fashion moving forward, thus ensuring that members finance the cooperative in accordance with benefits received and that each generation of members carries its own weight.²⁷⁸ Royer recognizes the potential limitations with respect to acquiring financing and lays out three possible strategies: (1) replacing equity

274. See Chickasaw Elec. Coop., *supra* note 257; Volunteer Energy Coop., *Form 990*, PROPUBLICA (2015), <https://projects.propublica.org/nonprofits/organizations/620395590> (select the "IRS Filing" PDF for 2015).

275. As noted previously, the decision not to distribute any excess proceeds may be made by the supplier in Tennessee, TVA, rather than by the individual cooperatives. See *supra* note 260; *Shadow v. Volunteer Elec. Coop.*, 448 S.W.2d 416, 419 (Tenn. 1969). This is discussed further later in this Article. See *infra* Subpart III.C.

276. In the event of a member's death, the bylaws vary across cooperatives and across states. Based upon the bylaws of Baldwin EMC (Baldwin County, Alabama), for example, management would be required to make a distribution if the legal representatives of the patron's estate were to request a distribution in writing. *Baldwin County Electric Membership Corporation Bylaws*, BALDWIN ELECTRIC MEMBERSHIP CORP. 16 (Nov. 4, 2016), <http://www.baldwinemc.com/wp-content/uploads/54758-BE-MC-Bylaws-SECURE-FOR-WEB-1.pdf>. However, even then, the required payout may be limited to a nominal amount, and members (or family of members) are not likely to challenge the REC or even to notify them in some cases. One of the authors of this study, however, notes that a dividend was paid by Baldwin EMC and received by said author during the year 2017. In a phone conversation on December 14, 2017, with a representative at Baldwin EMC, we were informed that the board determined that funds were available for dividends and paid them in 2017 to members of record as of 1991 through 2016.

277. See Jeffrey S. Royer, *Assessing the Ability of Rural Electric Cooperatives to Retire Capital Credits*, 31 J. COOPERATIVES 32 (2016).

278. *Id.* at 33.

with term debt, (2) reducing the rate at which equity is accumulated, and (3) adjusting electric rates.²⁷⁹

The average dividend payout ratio (dividends divided by earnings) averaged over 100% per quarter for investor-owned electric entities for each of the most recent six quarters (2016–2017), as reported by csimarket.com. In contrast, the dividend payout for RECs in our sample over the period examined averaged around 45%.²⁸⁰

We decided to investigate the erratic nature of profit distributions (or capital retirement) to members more closely. At the Cumberland Electric Membership Corporation (CEMC) cooperative, a footnote from the annual report reads as follows:

The Cooperative does not operate under a system of capital credits and has made no patronage refunds in either fiscal year; however, its books and records are maintained in such manner as to enable it to compute for each member the pro-rated capital contribution represented by retained net earnings for any given fiscal year.²⁸¹

When we contacted a former auditor of the cooperative to ask about the meaning of this footnote, we were told:

At their annual meeting each year, it is always reported that the net margin is for use of capital purposes, including construction, debt retirement, and all purposes including facilitation of general rate reductions. So basically, the pro-rata share is available, but the Cooperative does not distribute to the owners. Instead of distribution, they reinvest to benefit the owners.²⁸²

The problem with such ambiguous language as “all purposes including facilitation of general rate reductions” is that member-owners will find it extremely difficult to ascertain whether these investment decisions are (or are not) optimal, or even beneficial, for the member-owners.

The bylaws of CEMC state: “Upon the termination in any manner of a person’s membership, he or his estate, as the case may be, shall be entitled

279. *Id.* at 35–36.

280. In some instances, expenses were exactly equal to revenues (net margin of 0%), suggesting a possible misunderstanding of “nonprofit.” Nonprofit tax status does not mean revenues must equal expenses. Another possibility is that the entity distributes an amount equal to its margin. As noted later in this Article, the failure to distribute profits in Tennessee may be mandated by TVA, though the infrequent (or non-existent) distributions are not limited to the state of Tennessee. *See infra* note 297 and accompanying text.

281. This quote was from a footnote in CEMC’s 2014 financial statement, obtained through email correspondence with a former auditor (on file with author). For a condensed version of the financial statements for certain fiscal years up to the year ending June 30, 2014, see CUMBERLAND ELEC. MEMBERSHIP CORP., ANNUAL FINANCIAL STATEMENT: FINANCIAL REPORT 17 (June 30, 2014), <http://cemc.org/general/tmag/October2014.pdf>. *See also id.* (stating that the full annual audit report was available upon request).

282. Email from former CEMC auditor (Aug. 24, 2017) (on file with author).

to refund of his membership fee (and to his service security deposit, if any, previously paid to the Cooperative), less any amounts due to the Cooperative.”²⁸³ With respect to dividends, the bylaws of CEMC read as follows: “No interest or dividends shall be paid or payable by the Cooperative on any capital furnished by its patrons.”²⁸⁴ Note that dividends are not necessarily the same as refunds. Dividends generally refer to distributions of the excess of revenues over expenses, whereas refunds merely represent the return of the amounts paid in by investors (sometimes called “liquidating dividends”).

The capital, or owners’ equity, section of the balance sheet for RECs is difficult to understand, even for those familiar with annual reports for other organizational forms.²⁸⁵ In general, these cooperatives are obligated to account to all patrons for any amounts earned from furnishing of electric energy in excess of operating costs and expenses with the understanding that this excess becomes “capital” of the patrons, often listed as “patronage capital” or “accumulated capital” in the balance sheet.²⁸⁶

To the extent that this excess is not needed for specific purposes or to offset losses from current or prior fiscal years, a portion of the net margin (or excess of amounts earned over costs and expenses) should be allocated to patrons on a patronage basis, that is, in accordance with their electrical use. This is analogous to dividends paid to investors in an investor-owned entity. Investor-owned entities also reinvest earnings for the benefit of their shareholders. However, if dividends are withheld without specific explanation, investor-owned entities are likely to suffer repercussions.²⁸⁷

To illustrate these issues for two representative electric cooperatives, as well as the terminology that may be used in a cooperative that is analogous to the term “retained earnings” at an investor-owned entity, we include in the Appendix two sets of numbers: one for East Kentucky Power Cooperative, Inc. (EKPC) and the other for Volunteer Energy Cooperative (VEC). The first, in Illustration 1, is for EKPC for 2016 and 2015. In its reports,

283. *Bylaws of Cumberland Electric Membership Corporation*, CUMBERLAND ELEC. MEMBERSHIP CORP. 5, <http://www.cemc.org/articles/Bylaws.pdf> (last updated Apr. 25, 2014) (detailing the Interest of Dividends on Capital Prohibited policies). *See also supra* note 276 and accompanying text.

284. *Id.* at 13.

285. Interview with Paul Chaney, E. Bronson Ingram Professor of Accounting, Owen Graduate Sch. of Mgmt., Vanderbilt University, in Nashville, Tenn. (Nov. 15, 2017).

286. When not distributed, this is equivalent to what would be shown if the amounts were paid to patrons in cash and the patrons then furnished an equal amount back to the cooperative. For CEMC, the amount is labeled as “reinvested earnings.”

287. Such repercussions might include a depressed stock price, taxation of excessive retained earnings, or vocal dissension among shareholders. Retained earnings of investor-owned entities may be appropriated to signal an intent (e.g. plant expansion) and temporary reduction in dividends.

EKPC labels its accumulated profits of \$588,897,000²⁸⁸ as “Patronage and donated capital” in 2016, with \$2,000 invested capital labeled as “Memberships.” VEC lists “Membership Certificates” at \$434,580 and “Earnings reinvested in system assets” at \$226,926,116.

We see that EKPC’s “Patronage and donated capital” increased from \$535,189,000 at the beginning of 2016 to \$588,897,000 at the end of 2016. This increase equals their “Net Margin” of \$53,708,000.²⁸⁹ EKPC distributed no dividends to its patrons in 2016.

Similar results can be gleaned from the second table, Illustration 2, for VEC as of June 30, 2015. VEC’s net income totaled \$7,811,582 for the fiscal year ending June 30, 2015, increasing its “Earnings reinvested in system assets” from \$219,114,534 at the beginning of the year to \$226,926,116 at the end of the year. VEC distributed no dividends to its patrons in the year ending June 30, 2015.

Normally, in an investor-owned entity, if a company is run inefficiently, another company is likely to acquire the inefficient entity and run it more efficiently. However, in the case of RECs, the issues discussed in other Parts of this Article make takeovers sufficiently difficult in that inefficiently run cooperatives are likely shielded from a takeover. When no distributions are made to member-owners, there are at least two possible explanations. One is that there was no excess available to distribute. If so, why not? Perhaps the entity is run inefficiently, perhaps even struggling to survive. Another possibility is that managers take the excess to increase their own salaries, bonuses, or perquisites, exacerbating the conflict between manager and owner interests.

To illustrate this point more clearly, Table 2 shows a timeline of changes in owners’ equity for Appalachian Electric Cooperative, one of the four Tennessee cooperatives previously shown in Table 1. We see in the second-to-last column that the distribution or return of capital to members was zero for all years examined.

288. Other terms used by cooperatives for owners’ equity include “capital credits” and “member equity.”

289. See Statement of Revenue and Expenses and Comprehensive Margin *infra* Illustration 1 of the Appendix. The net margin is the fifth line from the bottom.

Table 2. Appalachian Electric Co-op—Statement of Changes in Net Assets
(dollars in thousands)

Year beginning July 1	Beginning Net Assets (Member Equity)	Prior Period Adjustment	Plus: Net Income	Plus/Minus: Pension Adjustments	Less: Distributions	Ending Net Assets
2007	\$63,910		2,429	64	0	66,403
2008	66,403		2,194	157	0	68,754
2009	68,754	2,665	3,083	822	0	75,324
2010	75,324		2,749	0	0	78,073
2011	78,073		3,640	12	0	81,725
2012	81,725		2,593	0	0	84,318
2013	84,318	-1,692	4,028	300	0	86,954
2014	86,954		3,063	41	0	90,058
2015	90,058		2,641	-23	0	92,676

It seems unlikely that most electric cooperative members understand the importance of these figures. Yet, in order to engage in active monitoring of corporate management, it is critical that the majority of members are able to understand the issues of financial reporting well enough to challenge the accumulation of earnings to be “reinvested in system assets” rather than returned to the members as “refunds,” “capital credits,” or “dividends.” Furthermore, the contrast between these values for electric cooperatives and an industry average dividend payout ratio of over 100% for investor-owned electric utilities is striking. Royer finds that the average cooperative could have replaced up to 25% of its equity with term debt during the period from 2006 to 2011 without reducing its equity share below recommended levels.²⁹⁰ Taken together, our analysis suggests, at a minimum, the potential for some electric cooperatives to make desirable takeover candidates.

This suggestive analysis about the attractiveness of RECs as potential takeover targets leads us next to consider the current feasibility of a takeover of an REC. To make our analysis as precise as possible, we need to delve deeply into the legal restrictions on such activity. Given the range of state laws on these subjects, we decided to focus our analysis of these legal questions on Tennessee law. While we recognize that there are differences between the states on some of these issues, we believe that Tennessee law is similar enough to the law in most other jurisdictions that our analysis has broad application. Tennessee’s role as the locus for TVA, and thus for the rural electrification movement, adds weight to this choice. However, there are some unique historical background issues affecting Tennessee RECs

290. Royer, *supra* note 277, at 46.

that we need to briefly explore before we move to our legal analysis. We turn to those questions in Subpart C.

C. TVA and Its Impact on Tennessee Electric Cooperatives

TVA has a profound impact on nearly every aspect of decision making for Tennessee electric cooperatives. Since the 1930s, it has been active in power generation and transmission. As it currently stands, TVA is required to operate its power division independently of all other programs, with its budget determined by electricity sales revenues and public debt offerings through the TVA fund. Its other programs, essentially vestigial remnants of the original objectives, are funded by congressional appropriations similar to other Interior Department appropriations.

TVA has a number of important legislative advantages that enhance its competitiveness. First, since the Energy Policy Act of 1992 (EPAAct), TVA has not been required to allow utilities from outside its service area to use TVA's transmission lines to provide power inside the service area.²⁹¹ Therefore, any utility intending to compete with TVA would be required to capitalize the cost to build all new transmission lines from its outset, a requirement effectively eliminating any competition for TVA. Second, TVA has an implicit interest rate subsidy for its public debt offerings.²⁹² While the debt is not backed by the full faith and credit of the federal government, "TVA bond yields are typically higher than Treasuries but lower than corporate bonds."²⁹³ Since TVA largely operates independently of the federal government, this low cost of capital allows TVA to borrow and spend exceedingly large sums of money with little recourse, subject only to a \$30 billion cap.²⁹⁴ Additionally, the income garnered from this debt is generally exempt from state income tax for the bondholder, further lowering TVA's cost of capital.

The net effect of all these subsidies and competitive advantages is a complete, legislatively protected monopoly in power production and transmission in the Tennessee Valley. As any good monopolist would do, TVA uses this negotiating position with its member cooperative customers. Under TVA's current contracts, electric cooperatives are required to furnish TVA with yearly audited financial statements.²⁹⁵ Additionally, TVA's board must approve any changes to the retail rates charged by the distribu-

291. See generally Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776.

292. 16 U.S.C. § 831n-4 (2012).

293. *Tennessee Valley Authority (TVA)*, INVESTINGANSWERS, http://tva.gov/file_source/TVA/Site%20Content/Footer/Freedom%20of%20Information/Annual%20Reports/foia_annual04.pdf (last visited Oct. 18, 2018).

294. 16 U.S.C. § 831n-4(a).

295. *French v. Appalachian Elec. Coop.*, 580 S.W.2d 565, 569 (Tenn. Ct. App. 1978).

tor cooperatives. These rates are not subject to review or approval by either the state public utility commissions or the Federal Electric Regulatory Commission. Next, TVA requires ten-year rolling contracts from all of its distributors, effectively imposing a ten-year cancellation notice with the added caveat that the cooperatives must solely rely on TVA's power while the contracts are in effect.²⁹⁶ Finally, TVA requires that the electric cooperatives not distribute any excess proceeds in the form of patronage refunds to their members, preferring capital investment instead.²⁹⁷

While TVA is in the position to charge monopolistic prices, it instead chooses to follow a regime of "public interest yet compensatory pricing." This pricing schema has resulted in Tennessee retail electric rates being between 15% and 25% cheaper on aggregate than the national average between 1990 and 2002.²⁹⁸ The cooperatives' residential rates have consistently been about 8% cheaper than the national average, and the overall real cost of power has decreased 15% over the last twelve years.²⁹⁹ These low rates do not necessarily suggest that RECs are efficient; the most important measure for determining the efficiency of RECs is to compare electricity distribution costs so that cooperatives are not improperly credited with the benefits of low wholesale power costs.³⁰⁰

A multitude of factors conspire to create these price advantages. First, TVA, as a wholly owned subsidiary of the federal government, is devoid of the profit motive of the investor-owned utilities, creating an instant price discount comparatively. As it is largely unaffected by market forces, it can sell power at whatever price it deems reasonable and then borrow to cover any shortfall. Second, TVA's implicit debt-backing lowers its interest expense substantially. Finally, through its system of dams, TVA has a healthy proportion of inexpensive hydroelectric power at its disposal, though it is only 18% of the TVA's total production capacity.³⁰¹

One important point that emerges from this discussion is that TVA would have to agree to allow M&A activity for Tennessee RECs, or at least be neutral to it, because it has control over the rates charged to RECs in Tennessee and effectively holds the RECs' power supply captive. While we

296. Dennis E. Logue & Paul W. MacAvoy, *The Tennessee Valley Authority: Competing in Markets for Capital and Electricity in Pursuit of Solvency*, 1 J. STRATEGIC MGMT. EDUC. 1, 5 (2003).

297. This at least is how Tennessee cooperatives interpret "an obscure paragraph in an early power purchasing contract." Cooper, *supra* note 13, at 340 n.35; *see also* Shadow v. Volunteer Elec. Coop., 448 S.W.2d 416, 419 (Tenn. 1969).

298. *State Electricity Profiles*, U.S. ENERGY INFO. ADMIN., <https://www.eia.gov/electricity/state> (last updated Jan. 25, 2018).

299. *Id.*

300. *TVA Rate Structure Change Won't Mean Much Initial Change to MTEMC Bills*, WBRY (Mar. 23, 2011), <http://www.wbry.com/node/3775> ("For every dollar the cooperative takes in, 80 cents goes straight to TVA to pay for power, and we operate on the other 20 cents.").

301. TENN. VALLEY AUTH., 2004 ANNUAL REPORT (on file with author).

are not well-positioned to assess how likely it is that the TVA would approve such changes, we will assume for now that it is possible that TVA would permit REC acquirers to step into the shoes of the cooperatives so that M&A activity could occur.

D. Rural Electric Cooperative Governance in Tennessee: The Legal Rules and an Overview of How They Impact M&A Activity

We now turn to the larger question of how cooperatives' legal structures serve to block the market for corporate control, again focusing on Tennessee as our case study. The law is complex and our discussion somewhat lengthy, but it is necessary to illustrate the high barriers that exist to any potential takeover. The gist, however, is simple and short: Tennessee law makes it almost impossible to take over a cooperative without the consent of its board.

The key legal rules that form part of the governance structure of Tennessee electric cooperatives are dictated by Tennessee law. Electric membership cooperatives operate as nonprofit corporations under Tennessee law and thus are predominantly governed by the provisions of the Rural Electric and Community Service Cooperative Act (RECSCA)³⁰² and the Tennessee Nonprofit Corporation Act (TNCA).³⁰³

Given the substantial deference afforded to cooperative boards to deviate from the statutory defaults and to fashion their own governance rules within their bylaws, the statutes and case law alone paint only part of the picture.³⁰⁴ The relative strength of members' rights within the governance structure of Tennessee nonprofit electric cooperatives can be conceptualized using a two-level approach: first are the baseline or default rules pro-

302. The provisions of the RECSCA are embodied in Title 65, Chapter 25, of the Tennessee Code. See TENN. CODE ANN. §§ 65-25-101 to -235 (2015). All citations to the RECSCA herein are to the Tennessee Code Annotated provisions.

303. See *State Policy*, TENN. ELEC. COOP. ASS'N., <http://www.tnelectric.org/issues/state> (last visited Sep. 5, 2018). It appears that most provisions of the TNCA apply to RECs, with exceptions specifically noted in the statute. See TENN. CODE ANN. § 65-25-125 (noting specific provisions of the TNCA that either do not apply to RECs or only apply with modification). The provisions of the TNCA are embodied in Title 48, Chapters 51–68, of the Tennessee Code Annotated. See *id.* §§ 48-51-101 to -68-105. All citations to the TNCA herein are to the Tennessee Code Annotated provisions. We note as well that, in 2009, Tennessee adopted the Electric G&T Cooperative Act to allow RECs and municipal power authorities to create and operate nonprofit entities to generate and transmit power. See *id.* §§ 48-69-101 to -123.

304. A good example of how these RECSCA provisions serve as defaults is Section 65-25-211(e), relating to proxy voting, which states that the bylaws *may* provide for voting by proxy, but “if the bylaws are silent on the manner of voting, voting shall be only in person.” Other statutory provisions under the RECSCA that defer to the cooperative's bylaws include Section 65-25-107(b) (removal of director(s) by members); section 65-25-108 (manner of conducting election by districts); section 65-25-107(c) (voting by mail ballot); Section 65-25-106(a) (bylaw amendments); Section 65-25-107(g) (powers reserved to members); and Section 65-25-107(c) (duration of period for providing notice).

vided for under the RECSCA and the TNCA and second are the scope of members' rights provided under the particular cooperative's bylaws.³⁰⁵

1. *Tennessee RECs' Basic Corporate Governance Rules*

The RECSCA grants cooperative boards substantial flexibility to fashion their governing rules within its structure. Each cooperative's charter basically contains the general mandatory provisions found in both the Tennessee Business Corporations Act (TBCA)³⁰⁶ and the TNCA.³⁰⁷ Though a cooperative's charter sets out its corporate purpose and the scope of the cooperative's rights and its board's authority, the substantive rules governing the cooperative are contained in its bylaws.³⁰⁸ The RECSCA places emphasis on the bylaws as the governing document, and the Tennessee courts have made clear that "[t]he by-laws of a corporation are as much a part of the law of that corporation . . . as are the charter provisions."³⁰⁹

The TBCA and the RECSCA provide different default rules regarding bylaw amendments: the TBCA generally grants authority to both the shareholders and the board to amend the bylaws, unless the charter reserves the power exclusively to the shareholders or excludes the board from amending a specific provision(s), while the RECSCA initially lodges power to alter the bylaws in cooperative members but allows them to share this power with the Board.³¹⁰ Both statutes allow the corporation to provide exculpatory clauses for directors for breach of fiduciary duty, subject to the same exceptions for breach of the duty of loyalty, bad faith, intentional misconduct, and unlawful distributions.³¹¹ The TNCA, however, goes beyond exculpation for breaches of fiduciary duty and further allows the corporation to provide in the charter for exculpation for *any* action taken as a director and separately permits the charter or the bylaws to provide for permissive *or obligatory* indemnification of any action taken as a director, subject to certain exceptions.³¹²

Tennessee courts have historically taken a distinctly noninterventionist

305. Out of the twenty-two cooperatives that are members of the Tennessee Electric Cooperative Association (TECA), fifteen had their bylaws available online.

306. See TENN. CODE ANN. § 48-12-102 (2012). The TBCA is embodied in Title 48, Chapters 11–27, of the Tennessee Code. See *id.* §§ 48-11-101 to -27-103.

307. See *id.* §§ 48-12-102, -52-102.

308. *Id.* § 48-52-102(b)(2). Out of the fifteen cooperatives for which bylaws were available online, only one of those also had its charter online (FLEC—contained in the same document as its bylaws—on the first two pages thereof). FLEC's charter essentially gives the cooperative and its board the right to exercise its power to the full extent provided for under the law.

309. *Middle Tenn. Elec. Membership Corp. v. State*, 246 S.W.2d 958, 959 (Tenn. 1952).

310. TENN. CODE ANN. § 48-20-201 (2012); § 65-25-106(a) (2015).

311. *Id.* §§ 48-12-102(b)(3), -52-102(b)(3) (2012).

312. *Id.* §§ 48-52-102(b)(5)–(6), -52-106(c)(1).

policy in regard to the actions of corporate boards; this is especially so for electric cooperative boards. Tennessee law regarding the actions of a corporation's directors is governed by the familiar "business judgment rule," which presumes a corporation's directors act on an informed basis, in good faith, and with the honest belief their actions are in the corporation's best interests.³¹³ This rule does not apply when the director or officer has an interest in the decision, does not actually make a decision, or makes an uninformed decision.³¹⁴

The business judgment rule in Tennessee is significantly bolstered by the broad immunity from suit legislatively granted to non-profit directors.³¹⁵ As a stated purpose in the Tennessee Code, "[t]he services of non-profit boards are critical to the efficient conduct and management of the public and charitable affairs of the citizens of this state."³¹⁶ Accordingly, the directors of nonprofit electric cooperatives have immunity from suit arising from the conduct of the cooperative's affairs. This immunity is to be removed only under what would amount to "willful, wanton or gross negligence."³¹⁷ However, while protecting the directors, this statute fails to grant immunity to the cooperative as a whole.

Directors have control over the economic distributions within an REC.³¹⁸ While they are only allowed to retain earnings that are reasonable for the operation of the business,³¹⁹ there is no oversight in determining what is reasonable, and most members of the cooperative do not have a sufficient understanding of the financial information needed to challenge a board's decision on what meets that standard. As previously described, analyses by Jeffrey Royer indicate that most cooperatives could expand the retirement of capital credits substantially without damaging their financial health.³²⁰ However, the retention of earnings gives management access to funds that can be used to entrench itself in power. For example, management can use these excess funds to lobby Congress for favorable treatment of RECs and for less regulatory oversight.³²¹ At some cooperatives, man-

313. *French v. Appalachian Elec. Coop.*, 580 S.W.2d 565, 570 (Tenn. Ct. App. 1978).

314. *McCall v. Scott*, 239 F.3d 808, 816 (6th Cir. 2001); *Lewis v. Boyd*, 838 S.W.2d 215, 220 (Tenn. Ct. App. 1992).

315. See TENN. CODE ANN. § 48-58-601.

316. *Id.* § 48-58-601(b).

317. *Id.* § 48-58-601(c).

318. CHARLES T. AUTRY & ROLAND F. HALL, *THE LAW OF COOPERATIVES* 80 (2009). This rule impacts potential merger activity. If members are disincentivized to push for a merger, and outside investors or firms are not interested in merging because of lack of information and return on investment, it is unlikely that a friendly merger will be proposed.

319. See *Cooper*, *supra* note 13, at 360.

320. See generally *Royer*, *supra* note 277.

321. See *Cooper*, *supra* note 13, at 342.

agement has used these funds to help set up takeover defenses.³²²

In accordance with their non-interventionist policy, Tennessee courts have consistently respected the cooperative's right to contract, refusing to substitute their judgment for the board's, barring acts inconsistent with the cooperative's bylaws or against clear statutory authority.³²³ Specifically for patronage refunds, in *Shadow v. Volunteer Electric Cooperative*, the Tennessee Supreme Court held that there was no compelling reason why the cooperative could not "contract to distribute excessive revenues by one or more of the optional methods authorized to the exclusion of the other optional methods."³²⁴ Furthermore, the statutory definition of "refund" with respect to electric cooperatives is the excess revenue after not only the typical operational and financial expenses, but also "in excess of the amount thereof necessary, to . . . [f]inance, or to provide a reserve to finance, the construction or acquisition by the cooperative of additional facilities to the extent determined by the board."³²⁵ Therefore, there are typically no refunds available for the cooperatives to distribute at the end of the fiscal year, as the boards generally soak up any additional capital for present or future capital investment.

Tennessee electric cooperatives are also subject to comparatively lax notification provisions concerning meetings, even compared to other nonprofits. For electric cooperatives, the standard nonprofit notice provisions are explicitly not applicable, and in their place are much less restrictive provisions.³²⁶ There is no requirement to describe matters to be discussed at the annual meeting if the transaction contains a conflict of interest.³²⁷ Additionally, the annual meeting may be announced with as little as five days' notice, compared to the typical ten-day notice provision.

More importantly, Tennessee electric cooperatives are not subject to typical member access to information regulations. Traditionally, most for-profit and nonprofit corporations are required to prepare a list of all members entitled to vote at the meeting and their respective shares or votes in the company.³²⁸ All members (or their representative attorneys) have the right to inspect this list, and a refusal to provide the list could result in the meeting being postponed until the list is furnished. The electric cooperative law in Tennessee, however, tacitly rejects the member access portions of

322. *Id.* at 340.

323. *Shadow v. Volunteer Elec. Coop.*, 448 S.W.2d 416, 418–19 (Tenn. 1969); *see also* *McCarthy v. Middle Tenn. Elec. Membership Corp.*, 466 F.3d 399, 406–07 (6th Cir. 2006) (noting that contractual provisions barring cooperatives from distributing patronage refunds are unreviewable by courts).

324. *Shadow*, 448 S.W.2d at 419.

325. TENN. CODE ANN. § 65-25-112(a)(3).

326. *Id.* § 65-25-125.

327. *Id.* § 65-25-111.

328. *Id.* § 48-57-201.

the corporate code.³²⁹ Explicitly rejecting the relevant code section and not replacing it with a suitable section evinces a legislative intent to minimize the notification duties of electric cooperatives. It is interesting to note that electric cooperatives are the only form of cooperative where this provision is abrogated, as it remains for all other cooperatives.

There are also limits on members' ability to bring derivative actions. In Tennessee, any representative suit by members demanding an accounting and distribution of excess revenues has been deemed a derivative action.³³⁰ However, there are some key barriers that prevent a plaintiff from winning such a suit. First, the plaintiff must show that he made a demand on the REC's board of directors, similar to the corporate context.³³¹ This requirement means that a plaintiff must either demand action from the board and that demand be refused, or prove to the court that demand would have been futile. Demand futility, in turn, requires showing that "the board is interested and not independent and [] that the challenged transaction is not protected by the business judgment rule."³³²

A second barrier to bringing a derivative suit lies in the requirement that a suit can only be brought by a minimum of fifty members or by members representing 5% of the voting shares of the REC, whichever is less.³³³ This requirement might be difficult to meet. First, the membership of an REC can be geographically dispersed, so it may be hard to personally contact that many members and persuade them to bring suit. Second, with somewhat limited ability to inspect records, it may be hard to even identify and contact the required number of members to convince them to join the suit.

A final barrier to bringing a derivative claim is that REC directors are granted broad immunity from suit challenging the affairs of the cooperative unless there is "willful, wanton or gross negligence."³³⁴ Therefore, it is unlikely that a court will grant any relief except possibly specific performance or injunctive relief that requires the directors to release some of the excess distributions. However, a suit is unlikely to get this far due to the difficulty in uncovering evidence showing such negligence and the costs of trying to obtain relief.

It is important to note, however, that in the context of RECs, a court is

329. *Id.* § 65-25-125.

330. *See* *McCarthy v. Middle Tenn. Elec. Membership Corp.*, 466 F.3d 399, 409 (6th Cir. 2006). This does not appear to be the rule in other states. See the discussion of recent capital credits litigation, *supra* note 253.

331. TENN. CODE ANN. §§ 48-56-401(c), 48-17-401(c).

332. *McCarthy*, 466 F.3d at 411 (quoting *Lewis v. Boyd*, 838 S.W.2d 215, 222 (Tenn. Ct. App. 1992)).

333. TENN. CODE ANN. § 48-56-401(a).

334. *Id.* § 48-58-601(c), (d)(2).

more likely to award reasonable expenses to the plaintiffs for a derivative claim.³³⁵ In this case, the plaintiff just needs to be successful “in whole or in part,” which allows them to recover reasonable expenses if the cooperative takes some action requested or if the plaintiff received anything from a judgment or settlement.³³⁶ This helps to alleviate one potential burden to bringing a derivative claim because it lowers the expected cost of a given suit. If plaintiffs believe that the suit will result in some relief being granted, they are more likely to undertake it because they will be able to defray their litigation costs if they obtain relief.

2. *RECs and Tennessee Takeover Law*

Acquirers have four major avenues for taking over a business entity: purchasing its assets, waging a proxy contest to replace management, initiating a merger between two entities, or conducting a tender offer for the outstanding entity interests. However, in the context of RECs, all four of these methods face barriers that make it virtually impossible to effect a hostile change-of-control transaction.

Before examining how these four methods might work (or not work) under Tennessee law, we should note that the Tennessee Electric Cooperative Act (TEC Act), like acts in most other states,³³⁷ is clearly hostile to acquisitions of RECs by investor-owned utilities. The “Legislative Findings” which open the TEC Act, adopted in 1988, state:

The general assembly finds that unfair and unwelcomed efforts may be made in Tennessee, as they recently have in other states, whereby absentee-owned profit power companies will attempt the acquisition of properties and the take-over of the businesses of rural electric cooperatives, and thereby disrupt Tennessee’s long-standing and successful policy of providing rural electric services through nonprofit, cooperative organizations. It is, therefore, in the public’s best interest that laws affecting such efforts will provide fair and equitable due process procedures and standards so as to ensure that such acquisitions will not be accomplished if inimical to the best interests of the rural citizens who will be affected.³³⁸

a. *Sales of Assets*

The Act includes provisions governing the merger of two cooperatives, or acquisition of one cooperative by another, but none for acquisition of a

335. *See id.* § 48-17-401(d)(1).

336. *Id.* § 48-56-401(f).

337. *See Cooper, supra* note 13, at 355 n.137 (“Most state co-op statutes have a variety of anti-takeover protections, particularly against [investor-owned utilities].”).

338. TENN. CODE ANN. § 65-25-101(b)(2).

cooperative by a private firm.³³⁹ This omission likely relegates potential private utility acquirers to using asset purchases as an alternative. Were a private firm to seek to take over a cooperative by acquiring all its assets, it would face a host of roadblocks. First, director approval would be required, and directors who refused to approve the sale would receive significant protection under the TEC Act. In its provisions on director liability, the TEC Act states that no director can either be removed from office or held

civily liable, for the reason that such director, in good faith and believing such to be in the best interests of the cooperative . . . failed or declined to support, or . . . opposed (1) [a] proposal to sell or lease[]all or a substantial portion of the cooperative's assets[;] (2) [a] motion to notify the cooperative's members of a proposal received by the cooperative for such a sale[;] or (3) [a] motion or any other effort to call a meeting of the cooperative's members to consider and act upon a proposal for such a sale³⁴⁰

The proposal itself would require heavy vetting under the statute; were one received, the TEC Act mandates that the REC's Board would then have to appoint an independent committee to "appraise and evaluate such assets and properties, including their going concern value and the values associated with the *right of the members to participate in the ownership and control of the cooperative*."³⁴¹ The committee would render its "highest determination of such present value," and the cooperative could not then make a sale for less than that value.³⁴² Once that task is accomplished, if it wished to continue, the Board would then be obliged to "transmit the appraisals, together with any underlying data and information that may have accompanied them, to every other cooperative that is engaged in business for the primary purpose and invite them to submit competing or alternative proposals."³⁴³

Assuming that, after all this, the bidder is still interested in the cooperative's assets, the sale would still have to be approved in a member vote, and not necessarily by a mere majority. The TEC Act establishes a sliding scale for member approval. If the purchase price is "less than sufficient to discharge or provide for the discharge of all of the cooperative's liabilities and, additionally, an amount equal to one hundred fifty percent (150%) of the cooperative's net worth," approval of 80% of the cooperative's total members is required.³⁴⁴ The percentage needed for approval decreases, however, as the value of the offer increases. If the offer is sufficient to dis-

339. *See id.* §§ 65-25-117 (consolidation of cooperatives), 65-25-118 (merger of cooperatives).

340. *Id.* § 65-25-107(b).

341. *Id.* § 65-25-113(a)(2)(A) (emphasis added).

342. *Id.*

343. *Id.* § 65-25-113(a)(2)(B).

344. *Id.* § 65-25-113(a)(1)(A)(vii).

charge all the cooperative's liabilities and is "equal to or greater than four hundred percent (400%) of the cooperative's net worth," approval by a mere majority of the cooperative's total members is required.³⁴⁵

All this would, one expects, discourage any prospective acquirer from trying to simply purchase the cooperative's assets. Attempts to wage a hostile takeover contest would also face steep challenges.

b. Proxy Contests for Cooperative Control

Regarding waging a proxy contest, the Tennessee statutes governing RECs differ from Tennessee corporate law in several key aspects. First, there are several differences in the method of member voting in an REC that make it difficult to even wage, let alone win, a proxy contest. Second, there are issues regarding the methods of elections for directors that compound the difficulty. Third, members have limited rights regarding the calling and conduct of meetings. Finally, there are general governance issues present in the statutes regarding bylaws and other matters that add further complications. This section will address each of these areas.

i. Voting in proxy contests.

The first major problem with waging a proxy contest for control of an REC is that under Tennessee law, the default statutory provision does not allow for proxy voting. However, individual RECs can permit proxy voting in their bylaws.³⁴⁶ In Tennessee, of the fifteen cooperatives whose bylaws are publicly available, we found three RECs with bylaws permitting proxy voting.³⁴⁷ Moreover, if it allows proxy voting, the REC can limit the topics for which such voting is allowed.³⁴⁸ Further, the statutory provision limits the number of members for whom an agent can act as a proxy. Generally, one member is limited to casting a proxy vote for only three other members.³⁴⁹ Limiting proxy voting makes it much more difficult for members to

345. *Id.* § 65-25-113(a)(1)(A)(i).

346. *Id.* § 65-25-111(e).

347. *See Bylaws*, APPALACHIAN ELECTRIC COOPERATIVE art. 1, § 3.5A, at 11 (Apr. 2018) [hereinafter *AEC Bylaws*], <http://aecoop.org/sites/aecoop/files/PDF/BYLAWS%200418.pdf> ("At any meeting of the members or any adjournment thereof, any member may vote by proxy, but only if such proxy [lists requirements to qualify for proxy]."); *Bylaws*, MIDDLE TENN. ELECTRIC MEMBERSHIP CORP. art. II, § 6, at 8 (Aug. 26, 2017) [hereinafter *MTEMC Bylaws*], <https://www.mtemc.com/sites/mtemc/files/images/PDF/Bylaws%20Amended%208-26-2017.pdf> ("At all meetings of members, a person may vote by proxy by one of the following methods: [lists acceptable proxy methods]."); *Bylaws*, SHENANDOAH VALLEY ELECTRIC COOPERATIVE art. III, § 6, at 6 (Nov. 29, 2016) [hereinafter *SVEC Bylaws*], <http://www.svec.coop/wp-content/uploads/2018/03/SVEC-Bylaws-January-2017-for-reading.pdf>.

348. TENN. CODE ANN. § 65-25-111(e).

349. *Id.* § 65-25-111(e)(2).

vote, as without it, they must attend the company's annual meeting in person.

Similar restrictions exist on members mailing in their absentee ballots to cast their vote. Again, the statutory default is to prohibit this method of voting unless explicitly granted in the bylaws.³⁵⁰ In Tennessee, we uncovered only two RECs with publicly available bylaws that provided this right to members.³⁵¹ Furthermore, the bylaws can limit the topics and manner of mail ballot voting in the same way they can limit proxy voting.³⁵²

Due to the limits placed on proxy voting and mail ballots, the election of directors most likely will take place with an in-person vote. While this naturally increases the difficulty of successfully replacing directors, the limits placed on voting rights in the REC context further complicate things. The first limit is that each member only receives one vote regardless of how much of an investment he has made in the REC.³⁵³ For example, assuming that membership interests were transferable (which is generally not the case³⁵⁴), a hostile bidder that successfully purchased the interests of many members in an REC would nevertheless be limited to validly casting one vote in any election of directors, no matter how many members' interests he had acquired. By contrast, in the corporate context a bidder that accumulated a large percentage of the stock of the company would be entitled to cast a proportionately larger percentage of the votes at the company's annual meeting.

The other major limit on voting procedures is that a quorum must be present at any meeting in order to conduct business.³⁵⁵ This limit requires either 2% of all members or one hundred members, whichever is less.³⁵⁶ While on its face this does not seem onerous because this number is lower than the requirement for normal corporations under Tennessee law, the requirement that these voters attend the annual meeting in person makes this requirement less likely to be met. Furthermore, this limit cannot be reduced

350. *Id.* § 65-25-111(e).

351. *See Bylaws*, SW. TENN. ELECTRIC MEMBERSHIP CORP. art. III, § 3.06 [hereinafter *STEMC Bylaws*], <http://www.stemc.com/sites/stemcstemc/files/images/Article%20III-%20Meeting%20of%20Members.pdf>; *Bylaws*, VOLUNTEER ENERGY COOPERATIVE art. III, § 3.06, at 18 (Aug. 2013) [hereinafter *VEC Bylaws*], <https://www.vec.org/wp-content/uploads/2013/10/ByLaws-cover-Aug-2013.pdf> (titled "Voting By Mail").

352. TENN. CODE ANN. § 65-25-111(e).

353. *Id.*

354. As we discuss below, members are not permitted to transfer their interests unless permitted by the REC's bylaws.

355. TENN. CODE ANN. § 65-25-111(d).

356. *Id.*

by the bylaws of a given REC.³⁵⁷ Moreover, at least one REC will not count mail-in votes to satisfy this quorum requirement.³⁵⁸

ii. How are directors nominated and elected?

Further complicating the voting issues above, REC directors can be elected by three different methods. To understand the various methods, the reader must first understand that in many states, including Tennessee, RECs can have complicated voting structures. Tennessee's statute allows for an REC to divide its membership into "equitable districts," which are geographical divisions that split the total area covered by an REC into similar portions, based on numbers of members served.³⁵⁹ Tennessee RECs have all divided themselves into several districts. For example, VEC provides for twelve equitable districts, while Gibson has eleven districts.³⁶⁰ The presence of these districts affects the method for nominating directors at many RECs.

Turning to the methods for nominating directors, the first is to nominate directors by equitable districts, but to vote at-large.³⁶¹ Under this method, the districts each have one director who serves from that geographical area, but each director has to be elected by a majority of all members. In other words, a director will be nominated by the members in their district, but the entire membership will be required to vote on each district's director at the annual meeting. This method is utilized by seven Tennessee RECs with publicly available bylaws.³⁶² This method complicates a proxy contest because a challenger would have to nominate directors for a majority of districts and win those elections in order to gain control of an REC's board of directors.

The second method is to nominate directors by district and elect them

357. *Id.* §§ 48-20-202, 48-57-203.

358. *STEMC Bylaws*, *supra* note 351, art. III, § 3.04 ("If mail balloting is otherwise allowed, ballots so delivered to the Cooperative shall not be counted in determining the existence of a quorum.").

359. TENN. CODE ANN. § 65-25-108(a)(2). For example, if an REC served 1,000 members, it may divide up into five districts, each serving 200 members, or alternatively, it may divide up into ten districts, each serving 100 members.

360. *See Bylaws*, GIBSON ELECTRIC MEMBERSHIP CORP. art IV, § 4.03, at 11 (Apr. 2012) [hereinafter *GIBSON Bylaws*], <http://www.gibsonemc.com/sites/gibsonemcgibsonemc/files/Bylaws.pdf>; *VEC Bylaws*, *supra* note 351, § 4.04, at 23.

361. TENN. CODE ANN. § 65-25-108(a)(1).

362. The Tennessee co-ops providing for this method are: CEMC, Holston, MTEMC, NGEMC, STEMC. *See Bylaws*, CUMBERLAND ELECTRIC MEMBERSHIP CORP. § 4.04, at 9 [hereinafter *CEMC Bylaws*], <https://www.cemc.org/articles/Bylaws.pdf>; *Bylaws*, HOLSTON ELECTRIC COOPERATIVE § 4.04 (Oct. 17, 2010) [hereinafter *HOLSTON Bylaws*], <http://www.holstonelectric.com/sites/holstonelectric/files/PDF/ByLaws%2010.10.17.pdf>; *MTEMC Bylaws*, *supra* note 347, § 2; *Bylaws*, N. GA. ELECTRIC MEMBERSHIP CORP. § 3.1 (Aug. 3, 2017) [hereinafter *NGEMC Bylaws*], <https://www.ngemc.com/Bylaws>; *SVEC Bylaws*, *supra* note 347, § 4.2(a); *STEMC Bylaws*, *supra* note 351, § 4.03.

at the district level.³⁶³ Under this method, the districts hold their own meetings to elect their representative on the board. In these cases, the election of the directors is done at more localized meetings of each district and not at the annual meeting attended by all members of the REC. This method is utilized by six Tennessee RECs with publicly available bylaws.³⁶⁴ This method is even more restrictive, since a challenger would not only have to elect directors that qualify for several districts, but would also have to obtain a majority of voting members' support within each district as opposed to winning an at-large vote.

Finally, at least one REC allows for some directors to be nominated at-large in addition to their district nominated directors.³⁶⁵ Under this method, each district is still allowed a representative on the board, but the board has more members than the number of districts. This leaves open director spots needing to be filled once every district has representation on the board, and these spots are filled by an at-large vote of the entire membership. While this is the most favorable method for a challenger, it only allows for the election of a limited number of at-large directors, which will not give the challenger control of the board. For example, if the board is composed of twelve members, nine of which are based on district voting and three of which are at-large, the challenger could likely expect to win at most four spots on the board, one for the geographic district where they reside and the three at-large spots. In this scenario, the challenger would still need to convince the members in at least three other districts to vote for a director that the challenger nominated in order to gain outright control of the board (seven directors on the twelve-person board). Otherwise, the challenger would have some voice in the operations, but not control (four directors on the twelve-person board).

A related problem regarding board elections in RECs is who controls nominations.³⁶⁶ In most Tennessee RECs, the board appoints a nomination

363. TENN. CODE ANN. § 65-25-108(a)(1).

364. The Tennessee co-ops providing for this method are: FLEC, Gibson, Pickwick, Plateau, UCCEMC, VEC. *Bylaws*, FORT LOUDON ELECTRIC COOPERATIVE § 4.06 (Oct. 4, 2008) [hereinafter FLEC *Bylaws*], [http://www.flec.org/sites/www/Uploads/files/Downloads/bylawsupdate2008-correct copy.pdf](http://www.flec.org/sites/www/Uploads/files/Downloads/bylawsupdate2008-correct%20copy.pdf); GIBSON *Bylaws*, *supra* note 360, § 4.03; *Bylaws*, PICKWICK ELECTRIC COOPERATIVE § 4.03 [hereinafter PICKWICK *Bylaws*], [http://d1rknsimzbp0zf.cloudfront.net/wp-content/uploads/2018/01/PE C-bylaws-2015-0118.pdf](http://d1rknsimzbp0zf.cloudfront.net/wp-content/uploads/2018/01/PE-C-bylaws-2015-0118.pdf); *Bylaws*, PLATEAU ELECTRIC COOPERATIVE § 4.03 [hereinafter PLATEAU *Bylaws*], <http://www.plateauelectric.com/?q=about/bylaws>; *Bylaws*, UPPER CUMBERLAND ELECTRIC MEMBERSHIP CORP. § 4.05 (Sept. 10, 2011) [hereinafter UCCEMC *Bylaws*], <http://www.ucemc.com/images/bylaws.pdf>; VEC *Bylaws*, *supra* note 252, § 4.05.

365. The only co-op that provides for at-large directors is CEMC. *See* CEMC *Bylaws*, *supra* note 362, art. IV, § 4.04.

366. *See* TENN. CODE ANN. § 65-25-108(a)(1)(A) (allowing for nominations to be made in "any other manner provided for in the bylaws").

committee that selects the slate of directors who will run for election.³⁶⁷ However, most RECs also allow members to add directors to the ballot by petition.³⁶⁸ Nomination by petition requires multiple members to sign a written notice, which must be submitted a certain number of days before the annual meeting, the number being specified by the bylaws for the given REC.³⁶⁹ Moreover, the notice of the election will clearly identify candidates nominated by petition. This may help the challenger by allowing those wanting new management to know which nominee to vote for, but could also hurt if the members choose to go with “the devil they know” instead of the one that they don’t know.³⁷⁰

Complicating things further, a challenger waging a proxy contest will in most cases face a staggered board implemented by the REC’s bylaws, making it impossible to quickly gain control of the board.³⁷¹ Staggered REC boards function much like a staggered board in the corporate context. The board is divided into a number of classes, with an equal number of directors belonging to each class.³⁷² For example, if a board of directors has

367. *E.g.*, *AEC Bylaws*, *supra* note 347, art. IV, § 4.6. This method is used by the following Tennessee co-ops: AEC, CEMC, DREMC, Gibson, MTEMC, NGEMC, STEMC, and SVEC. *Id.* art. IV, § 4.6; *CEMC Bylaws*, *supra* note 362, § 4.05; *Bylaws as amended*, DUCK RIVER ELECTRIC MEMBERSHIP CORP. art. IV, § 4.06 (Jan. 27, 2010) [hereinafter *DREMCE Bylaws*], <http://www.dremc.com/wp-content/uploads/2016/08/Bylaws-As-Amended-1.27.10-final.pdf>; *GIBSON Bylaws*, *supra* note 360, § 4.05; *MTEMC Bylaws*, *supra* note 347, § 4.3; *NGEMC Bylaws*, *supra* note 362, § 4.6; *SVEC Bylaws*, *supra* note 347, § 4.4; *STEMC Bylaws*, *supra* note 351, § 4.06.

368. *See, e.g.*, *Bylaws*, CHICKASAW ELECTRIC COOPERATIVE § 4.02 (Aug. 1, 2017) [hereinafter *CHICKASAW Bylaws*], <https://billing.cecpowerup.com/OSCP/Portals/0/Bylaw%20book%2008-01-2017%20%20Board%20Approved.pdf>. This method is used by the following co-ops: AEC, Chickasaw, CEMC, DREMC, Gibson, Holston, MTEMC, NGEMC, Pickwick, Plateau, STEMC, SVEC, UCCEMC, and VEC. *AEC Bylaws*, *supra* note 347, § 4.06; *CEMC Bylaws*, *supra* note 362, § 4.05; *DREMC Bylaws*, *supra* note 362, § 4.06; *GIBSON Bylaws*, *supra* note 360, § 4.05; *HOLSTON Bylaws*, *supra* note 362, § 4.06; *MTEMC Bylaws*, *supra* note 347, § 3.3; *NGEMC Bylaws*, *supra* note 362, § 4.06; *PICKWICK Bylaws*, *supra* note 364, § 4.06; *PLATEAU Bylaws*, *supra* note 364, § 4.06; *SVEC Bylaws*, *supra* note 347, § 4.4; *STEMC Bylaws*, *supra* note 351, § 4.06; *UCCEMC Bylaws*, *supra* note 364, § 4.06; *VEC Bylaws*, *supra* note 351, § 4.06.

369. *See supra* note 368. While these terms vary depending on the given REC, the range can be from as little as twenty days (Pickwick), or up to a hundred days (DREMC), before the meeting. One co-op that has its bylaws public allows for nominations from the floor, provided that the member submit a written statement agreeing to serve if nominated fifteen days before the meeting. *FLEC Bylaws*, *supra* note 364, § 4.06. It is unclear how potential challengers would comply with these time limits given that they can be given notice of the annual members’ meeting as little as ten days before it is held. *See* TENN. CODE ANN. § 48-57-105(c)(1) (mandating the minimum requirement of ten days’ notice).

370. For a general summary of the contested shareholder election voting literature, see Randall S. Thomas & Patrick C. Tricker, *Shareholder Voting in Proxy Contests for Corporate Control, Uncontested Director Elections and Management Proposals: A Review of the Empirical Literature*, 70 OKLA. L. REV. 9 (2017).

371. *CEMC Bylaws*, *supra* note 362, § 4.04 (providing for board members to serve staggered three-year terms). Co-ops are granted the ability to create staggered boards by Tennessee Code § 65-25-107(a), which gives RECs substantial flexibility when it comes to corporate governance in their bylaws.

372. In the cooperative setting, the bylaws can create four classes of directors, compared to three in the corporate context. *See* TENN. CODE ANN. § 65-25-107(d)(3) (granting the ability to create four classes).

nine directors, they may divide the board into three classes, with each class having three directors that hold office for a term of three years each. Once the board has been divided into these classes, only one class will be up for election in a given year. Only after three years does that class of directors stand for election again.

Further, in many RECs, each class is representative of only a few districts. For example, if an REC is divided into three classes and nine districts, each with one director, each year only three districts would hold an election. In essence, any given district would only be able to vote for a new director every third year.³⁷³ Therefore, someone wishing to gain control of the board would have to win at least two years of elections (in the given example) in order to elect a majority of directors.

Moreover, due to the RECs' bylaws, it is hard for members to remove a director without cause. Some bylaws do not even contain removal provisions,³⁷⁴ in which cases the removal must be for cause as provided in the statute.³⁷⁵ Those that do contain removal provisions typically require at least 10% of the members to petition for a director's removal.³⁷⁶ This sets a high bar for challengers who wish to try removing directors before their term ends. Further, even if the petition is successful, some RECs allow for vacancies to be filled by the board.³⁷⁷ In sum, it is extremely difficult for a challenger to replace REC directors outside of normally held elections.³⁷⁸

Several other factors regarding the board further complicate the proxy contest method of gaining control. Board members are typically required to be members of the REC.³⁷⁹ This rule restricts the ability of challengers to bring in outside experts to run as candidates for the board. A final obstacle for challengers is that incumbent directors can continue to hold their spot on the board if the REC fails to hold elections in a given year.³⁸⁰ For instance, the REC may fail to conduct an effective vote at the annual meeting if it cannot satisfy the mandatory quorum requirements. If this occurs, then

373. For example, Chickasaw co-op has this very structure. Each district is able to nominate one director for its spot on the ten-member board, and that director will serve a three-year term. See CHICKASAW Bylaws, *supra* note 368, §§ 4.01, 4.10–11.

374. See CEMC Bylaws, *supra* note 362.

375. TENN. CODE ANN. § 65-25-107(b) (stating that no director shall be removable except upon "a written charge . . . that such director has been guilty of an act or omission adversely affecting the business and affairs of the cooperative . . . amounting to actionable negligence . . . fraud or criminal conduct").

376. GIBSON Bylaws, *supra* note 360, § 4.06.

377. *E.g.*, MTEMC Bylaws, *supra* note 347, § 3.04.

378. However, some RECs reserve the right to fill vacancies to a special election. *E.g.*, HOLSTON Bylaws, *supra* note 362, § 4.08.

379. TENN. CODE ANN. § 65-25-110(a).

380. See HOLSTON Bylaws, *supra* note 362, § 4.04.

typically directors will hold over until the next meeting at which a quorum is present.³⁸¹

iii. Annual meetings and notice requirements.

RECs are required by statute to conduct annual meetings.³⁸² However, if an REC fails to hold an annual meeting, a court will only force a meeting if the board has eliminated all possible avenues for the members to hold a meeting to conduct business.³⁸³ This standard is nearly impossible to meet because RECs allow for members to demand a special meeting upon a petition signed by at least 10% of the members.³⁸⁴ In this event, however, challengers still have no recourse should the board fail to hold a special meeting because it is still not “impossible” to hold a meeting. While it seems likely that a court would force a meeting should a board delay or postpone a meeting indefinitely, under the current “impossibility” standard, it will be very difficult for a member to obtain judicial relief.³⁸⁵

The issues with meetings are compounded by issues regarding the notice-of-meeting requirements. As discussed above, most RECs require in-person voting, which is impossible if no meeting is held. It is also hard to accomplish when members are only given ten days’ notice of a meeting, the minimum required by statute.³⁸⁶ Further, the notice is only required to inform the members of the purpose of the meeting if it is a special meeting or “a regular meeting so requiring.”³⁸⁷ (Notice is not required at all for board meetings, except to board members when a special meeting is called.³⁸⁸) Given these requirements, REC members may lack the information required to know that they need to show up to a given meeting if one is held. Poor member attendance makes getting a quorum and holding an effective vote difficult. More generally, if members are not aware that there is important business occurring at a given meeting, there is less incentive for them to attend. This seems especially true when the REC membership is physically spread out and the members are unsophisticated consumers who have not previously taken an active role in REC management. From a challenger’s perspective, this is important because if a quor-

381. *E.g., id.*

382. TENN. CODE ANN. § 48-57-101(a) (“[A cooperative] shall hold annually a meeting of its members.”).

383. *Id.* § 65-25-125(b)(1) (qualifying that § 48-51-601 applies to electric cooperatives “except that the words ‘impractical or’ in [§ 48-51-601(a)] shall not be in effect”).

384. *Id.* § 65-25-111(b).

385. This is because under Tennessee Code § 48-51-607, relief may be granted from the requirements imposed by the Charter, bylaw, or Chapters 51 through 68 of Title 58.

386. TENN. CODE ANN. § 48-57-105(c) (mandating the minimum requirement and a maximum length of two months).

387. *Id.* § 65-25-111(c)(2).

388. *Id.* § 48-58-203(a)–(b).

um is not present at a meeting, business cannot be conducted and the meeting will be adjourned immediately.³⁸⁹ Any potential bidder would be wary of investing a lot of time and money in trying to gain control of an REC in these circumstances.

iv. Restrictive bylaws and limited member rights.

Dissidents who have not lost heart from the obstacles already discussed might still be deterred from bringing a proxy contest by REC bylaws that limit members' rights. REC bylaws are originally submitted by the board,³⁹⁰ meaning the board has power to craft their terms in its own interests. This does not appear at first blush to be a problem, as members are allowed to amend the bylaws by petition.³⁹¹ However, due to the voting and meeting issues just discussed above, it is procedurally difficult for members to do so. Moreover, boards can give themselves the joint power to amend the bylaws by putting such a provision in the REC's original bylaws.³⁹² Fortunately, in Tennessee, eight RECs have publicly disclosed bylaws that reserve amendment rights exclusively to their members,³⁹³ while one has actually granted the exclusive right to the board.³⁹⁴ Although the members are better off when they hold the right to amend, some of the bylaws limit this to petition proposals that are submitted a set time before a given meeting, making it procedurally more difficult to amend the bylaws.³⁹⁵

A second issue is that members can only take action by written consent in lieu of a meeting if the action is unanimously approved by the members, unless the bylaws provide otherwise.³⁹⁶ In practice, this means that all business must be conducted through meetings, which are subject to all the above issues, or by the board itself. Further, while members have the right to inspect corporate records, they are required to have a proper purpose that

389. See *STEMC Bylaws*, *supra* note 351, § 3.04.

390. TENN. CODE ANN. § 65-25-106.

391. *Id.* § 65-25-106(b).

392. *Id.* § 65-25-106(a)(1).

393. The Tennessee co-ops reserving the right to amend to the members are: FLEC, Gibson, Holston, MTEMC, Pickwick, Plateau, STEMC, and UCCEMC. FLEC *Bylaws*, *supra* note 364, § 15.01; GIBSON *Bylaws*, *supra* note 360, art. XVI; HOLSTON *Bylaws*, *supra* note 362, § 15.01; MTEMC *Bylaws*, *supra* note 347, art. XIII; PICKWICK *Bylaws*, *supra* note 364, § 15.01; PLATEAU *Bylaws*, *supra* note 364, art. XV; STEMC *Bylaws*, *supra* note 351, art. XV; UCCEMC *Bylaws*, *supra* note 364, § 15.01.

394. CEMC *Bylaws*, *supra* note 362, § 4.12. The CEMC bylaws provide: "These Bylaws may be changed (adopted, amended or repealed) by the Board of Directors." *Id.* There is no equivalent provision in the bylaws permitting members to do so. This appears to be in direct conflict with the statutory requirements in Tennessee Code § 65-25-106(a).

395. The exact length of time differs depending on the cooperative's bylaws. However, the lowest requirement is forty-five days in advance. *E.g.*, FLEC *Bylaws*, *supra* note 364, § 15.02 (requiring an amendment to be signed by fifty or more members and submitted forty-five or more days in advance of a meeting). The highest requirement is ninety days in advance. *E.g.*, AEC *Bylaws*, *supra* note 347, § 15.2.

396. TENN. CODE ANN. § 48-57-104.

relates to their economic interest of being an REC member.³⁹⁷ Initially, however, the board gets to decide if the member's purpose is proper.³⁹⁸ This makes it extremely difficult for a member to obtain information that will be necessary to inform other members about a possible change-of-control transaction, because the board could deem the purpose improper. A member does have the right to challenge that decision in court,³⁹⁹ similar to a corporate shareholder's right to sue on the issue. While this avenue is available, it delays access to the necessary information while the litigation is pending. This option further adds to the cost of the takeover attempt by adding litigation and court fees to the expected price of any takeover deal.

c. Friendly Mergers

A third method of acquiring control of an REC would be for one cooperative to approach a second cooperative's management with a friendly merger proposal.⁴⁰⁰ However, if the targeted cooperative's management wishes to remain in power, it will be difficult to get them to agree to a merger.⁴⁰¹ There are several reasons why this is the case. First, without target management's approval, a challenger would be required to undertake a proxy contest and win the election in order to get favorable management on the board. As discussed above, this is a very difficult, if not impossible, task. Second, RECs have limits on outside investment, which can make it difficult to finance a merger. And third, the board's control over distributions can cause problems for the challenger. We next explore these latter two issues in turn.

i. Voting barriers and proxy issues.

One of the major issues with pursuing a merger with an REC is that both target management and the cooperative's members would have to separately approve the transaction. Several problems will arise with obtaining the needed approvals. First, the board is likely to vote against any unsolic-

397. *Id.* § 48-66-102(b)-(c).

398. *See City of Franklin v. Middle Tenn. Elec. Membership Corp.*, No. M-2007-1060-COA-C3-CV, 2009 Tenn. App. LEXIS 524, at *3-5 (Tenn. Ct. App. July 31, 2009).

399. *See id.* at *6.

400. This type of transaction is statutorily authorized under Tennessee law. TENN. CODE ANN. §§ 65-25-117 (consolidation of cooperatives), 65-25-118 (merger of cooperatives). Surprisingly, there is no statutory provision in the Tennessee Code for mergers between a cooperative and another type of entity, such as a public utility. Under limited circumstances, three hundred or more members of the target cooperative may petition the cooperative to mail to the cooperative's members a statement in opposition to a proposed transaction, their own recommendation, or both, that a competing merger proposal be accepted. *Id.* §§ 65-25-113(a)(2)(D), 65-25-118.

401. Out of the handful of successful takeovers of RECs by investor-owned utilities, many appear to involve board acquiescence in the deal; in other words, they were friendly, not hostile, takeovers. *See Gallant, supra* note 240.

ited merger. Therefore, in order to obtain the approval of the board, it is likely that a challenger would need to first undertake a proxy contest, which, as explained above, faces high barriers.

Even if a challenger were able to convince the target board to vote for a merger, similar voting barriers might prevent the members from approving the transaction. First, the members would have to be informed of the possibility of the merger and show up to a meeting in order to achieve a quorum.⁴⁰² Second, the members would have to be willing to sell their stake in the REC. Recall that the members of an REC are also its customers. These end-users have become members in the electric utility primarily to gain the benefits of electricity and not to collect the benefits of an investment.⁴⁰³ Some REC members might not be willing to forego membership in a cooperative organization for the benefit of a one-time financial gain arising from the sale to a third party.⁴⁰⁴

Further, there is typically a supermajority requirement for any fundamental change such as a merger.⁴⁰⁵ Therefore, even if a quorum were present at a given meeting, there may not be enough members physically present at the meeting to approve such a transaction, even if everyone in attendance approved. Due to the supermajority voting requirement, a merger or other transaction may be nearly impossible.⁴⁰⁶

ii. Restrictions on outside investments.

Limits on outside investments in RECs may also dissuade a challenger. Typically, a member of an REC has a stake in the REC due to his use of the electricity.⁴⁰⁷ In fact, investment in the member interests of an REC is typically limited to one interest per member, since voting rights are one vote per member.⁴⁰⁸ This naturally limits the amount a member would invest in a given REC (though the member's economic stake may be larger due to retained earnings). The only exception is that an REC is allowed to offer preferred shares that will pay a fixed dividend to attract investment when necessary.⁴⁰⁹ These shares carry no voting power and their yield is typically limited by law.⁴¹⁰

402. See *supra* Part I.

403. See Cooper, *supra* note 13, at 356.

404. For example, members might be concerned that if they are served by a privately owned utility, they would not be eligible for rebates and cost savings that might be passed through to REC members.

405. See Cooper, *supra* note 13, at 361–62.

406. *Id.*

407. ATRY & HALL, *supra* note 318, at 72–73.

408. *Id.*

409. *Id.* at 73.

410. *Id.*

The combination of these two facts makes outside investment nearly impossible and lowers the incentive to attempt to takeover the REC if one is not already a member. To begin, member voting power in an REC is limited to one vote per member, which means there is no way to acquire additional votes by purchasing extra member interests. Secondly, with limited potential returns on outside investment in the REC, a non-controlling outside investor will be unable to reap large financial rewards from their stake unless they are able to gain control of the REC. Even then, if an REC board of directors has channeled most of the potential value to its member-customers⁴¹¹ rather than diverting the firm's profits to enriching itself, there may be little financial gain to be had initially by an outside investor.

A secondary point to be raised regarding investment and mergers generally is that one strong economic argument in favor of merging RECs and investor-owned utilities—that is, to create economies of scale and lower the cost of providing electric power—has been weakened by the Electric Generation & Transmission Act.⁴¹² This act allows existing RECs to form a G&T cooperative, which creates the potential for recognizing economies of scale without the need for consolidations.⁴¹³ Since economies of scale can be obtained while retaining existing management, there is less economic incentive for the managers to seek a friendly merger to produce better returns for REC members.

d. Tender Offer Issues

A would-be acquirer's final option is the use of a tender offer to purchase the outstanding membership shares. However, this method faces enormous difficulties in the REC context. The most pressing issue that prevents a tender offer in the cooperative context is that members are not allowed to transfer their interest unless provided for in the bylaws.⁴¹⁴ This statutory default, along with the one-member, one-vote rule of coopera-

411. This is built into the nature of the cooperative, which exists as a business form to pass through its earnings as cost savings to the customers (members).

412. TENN. CODE ANN. § 48-69-102(b).

413. The act allows for a cooperative to be formed where the members of the cooperative are other cooperatives, in this case RECs. *Id.* § 48-69-112. The RECs are then able to use the larger cooperative structure to help ensure electricity at “the lowest feasible cost” instead of formally merging with other RECs or other electricity providers. *Id.* § 48-69-102(c).

414. *Id.* § 65-25-111(a)(4). Of the RECs with publicly available bylaws, none allow for the free transferability of membership interests. SVEC expressly prohibits the transfer of shares, unless given board approval. *SVEC Bylaws*, *supra* note 347, art. I, § 11. All the other bylaws provide for some transfers in case of death or if a member moves within the service area. However, any of these transfers require board approval as well.

tives, renders the use of a tender offer for an REC impossible.⁴¹⁵

However, assuming that members could transfer their interests in a cooperative, there would still be several problems with using the tender offer to bring about a change-of-control transaction. First, dissidents are limited in their ability to obtain voting rights by acquiring shares in a tender offer. Second, the outside investment limits discussed above will create barriers for any non-member attempting to acquire shares. Third, management control over distributions disincentivizes takeover attempts and sways members to favor incumbents. Finally, members have limited access to the records of an REC due to the proper purpose requirement, which makes it difficult for an acquirer to inform members about their tender offer's existence. This section will discuss these issues in more depth.

i. Voting and proxy issues.

The first issue in conducting a tender offer arises out of the design of voting within an REC. Every member only has one interest and one vote.⁴¹⁶ This creates a collective action problem because it means that, in order to accumulate a large block of member interests, more people independently have to decide to tender their interests into the offer. By comparison, when the target is a normal corporation, a tender offer may be easier to conduct because one shareholder may control a larger number of shares of the outstanding stock, and the acquirer can acquire the entire block by persuading one person to sell. A further issue is that the members typically hold an interest in an REC because of their usage of the electricity generated.⁴¹⁷ Therefore, it seems less likely that a member would be interested in tendering their membership interest if they do not recognize the potential for greater savings.

A second issue arises when considering the geographic spread of the membership base. A tender offer would have to reach the entire membership base to persuade a majority of members to tender into the offer, which may prove difficult given the physical spread and the remoteness of the members. Moreover, these members may not pay attention to a tender offer because they have a small economic investment in the REC. Even if a member were to learn of the tender offer, they may not realize the economic gain to be had unless they know whether it is a fair price. Further, even if an offeror were able to buy a block of shares of the REC, they are still limited by the one-member, one-vote rule, which makes it difficult for them to

415. Moreover, it should be noted that while there is nothing to say that a cooperative cannot attempt a poison pill, it need not worry about such defenses when its members cannot transfer their membership interests to a potential hostile bidder.

416. ATRY & HALL, *supra* note 318, at 72–73.

417. See Cooper, *supra* note 13, at 346–47.

exercise control, even with ownership of a majority of the shares.⁴¹⁸

A final issue can be seen by looking at the proxy and mail-in voting rules of most RECs. Since most members cannot vote on REC business without attending a meeting, it is unlikely they would pay close attention to a tender offer unless they were specifically solicited. Members may believe that any important business of the REC will be conducted at the annual meeting and therefore may not pay attention to a general solicitation. If this is true, the problem will be worsened by the issues discussed below regarding the access to REC information, which may prevent an offeror from directly soliciting interests from existing members.

ii. Outside investment limitations.

A second set of potential barriers arises from the fact that outside investment is limited in an REC. As discussed above, typically RECs only receive investments from their members, who are the end-users of the REC's services.⁴¹⁹ Therefore, an outside investor would find it difficult to buy interests due to the limits on their investment.⁴²⁰ This implies that only a member would be incentivized to attempt a takeover of an REC. The limits on the amount of investment and the lack of financial incentives to be gained create a barrier to a tender offer.

iii. Distribution issues.

The third area where an investor would find possible resistance to their tender offer stems from the incumbents' ability to control distributions. Members may be influenced in their decisions about a tender offer if the incumbents' offer refunds or offers to return capital in the face of a tender offer. If the members see management as representative of their interests, even if belatedly, and believe that there is still value in being a member of the REC, the challenger will have a hard time acquiring the membership interests through a tender offer.

iv. Restrictions on the inspection of member lists and books and records.

A final area of concern for a tender offer is the right to inspect REC records. Management can make it difficult to access member information.⁴²¹ A challenger may not, therefore, be able to directly solicit ten-

418. ATRY & HALL, *supra* note 318, at 75-76.

419. *See supra* Part I.

420. The main limit on outside investment is the preferred share structure of membership interests discussed above. If outside investors cannot gain more control and voting power through investing more capital, they are unlikely to increase investment through the use of a tender offer.

421. *See supra* Section III.D.1.

ders and instead would need to rely on a more general method, making it harder for the offeror to acquire enough shares to gain control. This issue may be the most difficult to overcome due to target management's ability to deny a request for information if they deem it to not have a proper purpose.⁴²² Without access to member information to provide the offer directly, the challenger will find it difficult to gain control and may be dissuaded from the attempt entirely.

A related issue is that the challenger may not be able to examine the REC's financial information to determine if it is worthwhile to take over the REC.⁴²³ If the challenger does not know that it can improve the REC financially, the challenger will lack incentive to attempt a takeover in the first place. However, there is one way that a member may be able to obtain some financial information. Under Tennessee law, a cooperative is required to disclose limited financial information at an annual meeting.⁴²⁴ While there are difficulties of getting members to attend an annual meeting, let alone getting the meeting to be held, as discussed above, a member who wished to pursue a tender offer would be able to obtain some useful information by attending a meeting at which a quorum was present.

e. Summary

In short, there are four potential ways that a challenger can gain control of a normal business entity: through an asset purchase, a proxy contest, a merger, or a tender offer. However, for RECs there are significant barriers that actively discourage or block a takeover using any of these methods. While a majority of these problems stem from the voting structure and lack of proxies in the REC context, several other issues arise when attempting a merger or a tender offer. All of these problems combine to make it nearly impossible for an REC to be taken over, regardless of how poor the management is and how little value is being passed through to the members. We next illustrate these problems with a case study of a Tennessee REC.

E. A Case Study of Middle Tennessee Electric Membership Corporation

While none of the RECs in Tennessee are likely takeover targets under current law, we decided to examine the one that seemed the most susceptible to a hostile transaction, Middle Tennessee Electric Membership Corporation (MTEMC), to illustrate some of the points made in the previous

422. See *supra* Section III.D.1.

423. See *supra* Section III.D.1.

424. TENN. CODE ANN. § 48-57-101(c).

section.⁴²⁵ There are several unique features of MTEM C, some of which make it seem easier to take over as compared to the other Tennessee RECs, for which information is publicly available.⁴²⁶ First, MTEM C allows for a form of proxy voting, which most Tennessee RECs do not.⁴²⁷ Second, MTEM C allows for the removal of a director for cause by membership petition.⁴²⁸ Third, MTEM C allows for director nominations by membership petition in an election contest.⁴²⁹ Fourth, MTEM C's board is composed of three classes of directors, which allows for control of the board to occur after two annual meetings.⁴³⁰ Finally, the composition of the directors is designed to represent only four equitable districts, each with a specified number of directors, allowing for a dissident to take over with majority support in only two of the districts, instead of over a larger geographic region.⁴³¹ While these features allow for the best chance of success in a proxy contest or a friendly merger, it is still difficult to take over MTEM C using either strategy. Moreover, a tender offer is impossible, as each member only receives one vote regardless of the economic interest that member holds.⁴³² If management is unwilling to agree to a friendly deal, the best strategy is to attempt a proxy contest for majority control of the board.

The staggered board of MTEM C consists of eleven directors divided into three classes: one consisting of three directors and the other two consisting of four directors each.⁴³³ Each director is elected to a three-year term, so only some directors are elected each year.

One important consideration for engaging in this takeover technique is how to focus resources into the districts that would provide for the best chance of success. MTEM C has four districts: two have three directors, one has four directors, and one has one director.⁴³⁴ This indicates that resources could be focused primarily in the two districts with three directors each, allowing for six spots on the board.⁴³⁵ It is unclear from MTEM C's bylaws which districts are placed in each class on the board of directors, but as-

425. MTEM C is the sixth largest electric cooperative in America. *About Us*, MIDDLE TENN. ELECTRIC MEMBERSHIP CORP., <https://www.mtemc.com/About-Us> (last visited Oct. 19, 2018).

426. We examine MTEM C in some detail not because we have any views as to whether it is a good takeover candidate or not; rather, we examine it because it would be easier to take over than most other Tennessee RECs about which we have data.

427. MTEM C *Bylaws*, *supra* note 347, § 2.06.

428. *Id.* § 1.15.

429. *Id.* § 3.03.

430. *Id.* § 3.02.

431. *Id.* § 3.01.

432. *Id.* § 2.05.

433. *Id.* art. III, § 2.

434. *Id.* § 1.

435. *See id.* These counties are Williamson and Rutherford (districts 1 and 2). However, resources could be focused on Williamson County, which gets four directors, for a greater chance of gaining control with the lowest geographic spread.

suming these two districts line up with the years of four director spots up for election, this would be the best strategy.

MTMEC's governance structure creates two important features that benefit dissidents. First, its members are allowed to nominate a member to the slate of director nominations if fifteen or more members sign a petition and submit the petition sixty days prior to the meeting at which the election will be held.⁴³⁶ This allows for a dissident to place his potential directors' names onto the election slate without relying on the support of the MTMEC nomination committee. However, these candidates would have to satisfy the qualifications set forth in the bylaws, which include that the proposed directors be current members residing in the subdistrict that they represent.⁴³⁷ This would be a potential complication, but would not prevent a takeover as long as the dissident was able to find support within any given subdistrict. The second beneficial feature is that directors for any given subdistrict are voted on by the entire membership.⁴³⁸ This allows for a contested election to be won even if the dissident was not widely supported in the given subdistrict itself.

However, this strategy faces two major challenges. First, even though proxy voting is allowed, a member may represent only one other member by proxy at a time.⁴³⁹ This would require the dissident to enlist many members to hold proxy votes in order to win a given election. For example, if the dissident wanted to control over 50% of the vote, he would need at least 25% of the membership to be willing to vote in person and another 25% to give proxies to those voting in person. While the proxy voting eases the burden to some extent, the one-proxy numerical limit still makes a proxy contest difficult.

The second major problem is the classified board. It ensures that any potential change of control will be delayed for at least two annual meetings if no directors are removed for cause during that time. This delay may be seen as too risky for a dissident to attempt a proxy contest. However, the dissident may want to offer a merger proposal, after gaining some representation on the board, and use that representation to help sway the board into approving a merger to avoid the long delay. In the end, while it is theoretically possible to engage in a takeover by engaging in a proxy contest, even the RECs that allow for this avenue have other limitations that make it extremely difficult for a dissident to succeed.

436. *Id.* § 3.

437. *Id.* § 2.

438. *See id.* art. III, § 5.

439. *Id.* § 6.

F. Opening Up the Market for REC Control

Based on the analysis in the previous two Subparts, we conclude that the market for corporate control for RECs is currently closed. In other words, the likelihood of a successful hostile change-of-control transaction at present seems to be essentially zero. The legal barriers created by state law, as evidenced by our detailed examination of Tennessee law, are high and almost impossible for even the most determined acquirer to surmount. Friendly transactions are also quite difficult to accomplish, even assuming that existing REC managers and directors would be willing to give up their current positions. If our first policy option—opening up the market for corporate control to create strong monitoring forces that could reduce the gap between managers' interests and members' interests—is to become feasible, major changes in the current legal rules will need to take place.

At a minimum, we think that two major legal regimes will need to be changed. First, we would propose that all RECs should be subject to the same state rules as all other corporations. For example, in the case of Tennessee, all Tennessee RECs would have their basic manager and member relationships and the rules concerning M&A governed by the Tennessee corporation statutes. While there are some differences between the interests of corporate shareholders and REC members, none of these differences justifies perpetuating the enormous gap between the interests of REC members and those of their RECs' managers and boards of directors. The current separation of ownership and control imposes significant costs on REC members while providing them scant benefit, and there is little reason to perpetuate those costs when the alternative is to use state corporate law that was designed to minimize just such agency costs.⁴⁴⁰ Put slightly differently, state corporate law already minimizes the agency costs of equity ownership and has been laboriously developed over decades to perform that function. It makes perfect sense to employ it as the default rules for REC governance.

However, that change by itself is unlikely to be sufficient to open up the market for corporate control. In addition, we think it necessary to complement a movement to apply state corporate law to RECs with federal legislative action to make clear that REC member interests are securities under the federal securities laws. At present, it is uncertain that REC member interests are securities for purposes of the federal securities laws.⁴⁴¹ This

440. There is extensive literature about the efficiency of state corporate law. For a summary of the literature, see ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 152–73 (Foundation Press 2d ed. 2010).

441. There is some doubt that member interests are securities under the federal securities laws. Cooper, *supra* note 13, at 357 n.159; see also Carol R. Goforth, *Application of the Federal Securities Laws to Equity Interests in Traditional and Value-Added Agricultural Cooperatives*, 6 DRAKE J. AGRIC.

means that the disclosures made by cooperatives at present need not and do not comply with the provisions of § 14 of the 1934 Exchange Act.⁴⁴² As a result, REC members neither receive the informational disclosures that are mandatory for corporate shareholders, nor are they eligible to freely use proxy voting.

We call for Congress to amend the definition of security that is contained in the 1933 Securities Act⁴⁴³ and 1934 Exchange Act to explicitly include REC member interests. This would have the salutary effect of (1) requiring all RECs that otherwise satisfy the criteria to be registered companies under the federal securities laws, which would mandate that they make additional disclosures to their membership that are of the same quality and quantity as those required for registered corporations, and (2) forcing RECs to permit proxy voting for their members. While we are not sure that all RECs would satisfy the criteria for becoming registered companies, RECs that own more than \$10 million in assets and have 2,000 or more members (or 500 persons who are not accredited investors) would be required to register with the SEC.⁴⁴⁴

While experience will show if there are additional legal rules that need to be changed in order to create a market for corporate control for RECs, we think it is useful to pause here and admit candidly that the two major legislative changes we have proposed are unlikely to occur unless there are significant changes in the existing political environment. With a few exceptions, there appears to be little political support for changing the existing system for electricity distribution in rural areas and a good deal of political opposition to allowing hostile takeovers, or even friendly mergers, of RECs. Given these difficulties, we turn in Part IV to development and consideration of our second potential policy option: retasking RECs for the future with a new mission of bringing internet access to rural America and reinvigorating their regulator to act as a monitor of the resulting agency costs that would accompany such a change.

L. 31, 40 (2001) (discussing reasons why cooperatives do not share the same characteristics as stock corporations); Kathryn J. Sedo, *The Application of Securities Laws to Cooperatives: A Call for Equal Treatment for Nonagricultural Cooperatives*, 46 *DRAKE L. REV.* 259, 259–60 (1997) (reviewing case law on cooperative interests as securities).

442. See 15 U.S.C. § 78n (2012).

443. 15 U.S.C. § 77b(a)(1) (2012).

444. If member interests are securities, then § 12(g)(1) of the 1934 Exchange Act applies. 15 U.S.C. § 78l(g)(1) (2012). One commentator has gone further and suggested that “[i]nformed co-op members should vote to take their co-op public on the NASDAQ stock exchange.” Cooper, *supra* note 13, at 374.

IV. IS THERE A FUTURE ROLE FOR RECS AS RURAL INTERNET PROVIDERS?

Electrification is not the only task RECs have undertaken.⁴⁴⁵ When rural electrification was nearing completion in the 1950s, RECs helped to expand rural telephone service, another task at which they succeeded. Now, some states are wondering whether RECs should be asked to shoulder a similar job and help expand rural internet networks. In this Part, we explore this new objective for RECs and document existing efforts in some states to bring it into reality. We caution, though, that merely assigning RECs this new task will not cure their ills. In exchange for federal support of this new mission, we call for the creation of an active monitor to ensure that REC management's interests are brought in line with those of its members. Given the political difficulties in changing legal rules to permit the creation of market forces that we documented in the last section, we argue that the alternative is to reinvigorate a government regulator, such as the New Deal-era REA (now the RUS), to act as a serious monitor of the REC's management and board of directors.

A. Can RECs Provide Broadband Internet Services to Rural Areas?

RECs now engage in a wide variety of activities. Their national lobbying organization, the NRECA, routinely highlights the diverse services that its members provide, identifying three areas in particular: (1) energy and technology; (2) community development; and (3) the cooperative advantage.⁴⁴⁶ In its 2016 annual report, the NRECA also highlighted cooperatives' involvement in increasing voter turnout, international efforts to enhance electrification, and electricity storage.⁴⁴⁷ However, one of the most controversial expansions of cooperative activity is the endeavor to provide broadband internet to rural communities.

Internet access has swiftly become a necessity to everyday life. In 2016, the United States Court of Appeals for the District of Columbia Circuit affirmed a ruling that classified internet as a basic utility, thus placing internet access in the same category as access to electricity and water.⁴⁴⁸ While most rural areas have basic dial-up internet access, a high percentage are unable to obtain broadband internet services. According to a 2016 Brookings Institute report, 39% of rural residents do not have broadband

445. KLINE, *supra* note 48, at 219.

446. Nat'l Rural Elec. Coop. Ass'n, 2016 NRECA ANNUAL REPORT 12 (2016), http://www.electric.coop/wp-content/uploads/2017/04/2016_NRECA_Annual_Report.pdf.

447. *See id.* at 6–16.

448. U.S. Telecom Ass'n v. Fed. Commc'ns Comm'n, 825 F.3d 674 (D.C. Cir. 2016); *see also* Cecilia Kang, *Court Backs Rules Treating Internet as Utility, Not Luxury*, N.Y. TIMES (June 14, 2016), https://www.nytimes.com/2016/06/15/technology/net-neutrality-fcc-appeals-court-ruling.html?_r=0.

internet access, compared to only 4% of urban residents.⁴⁴⁹ Many commentators believe that the digital divide directly threatens the livelihood of rural America—much like the lack of electricity did eighty years ago.⁴⁵⁰

Mirroring their New Deal electrification efforts, many electric cooperatives are actively expanding broadband access into rural communities by adding internet as an offered service.⁴⁵¹ With many telecom providers dissuaded by the high cost of infrastructure build out, and considering the low population density with reduced revenue opportunities, some electric cooperatives are filling this void.⁴⁵² Currently, fifty-two electric cooperatives have expanded or plan to expand broadband internet access to rural areas.⁴⁵³ While this is not a huge number, in 2010 only one electric cooperative offered broadband internet access.⁴⁵⁴ And this number is likely to increase simply because of the similarities between the challenges of providing internet and those of providing electricity. In many instances, electric cooperatives are using the same utility poles for fiber optic cables.⁴⁵⁵

Despite political opposition,⁴⁵⁶ some states have moved to allow, and even encourage, RECs to provide broadband service in their service areas, in part because existing telecom companies are unwilling to expand services due to the low profit margins that would likely result.⁴⁵⁷ Tennessee, for example, recently passed the Tennessee Broadband Accessibility Act (Tennessee Broadband Act) to allow electric cooperatives to legally sell broadband internet services.⁴⁵⁸ That said, RECs may be an imperfect solution to the problem. In Virginia, for instance, BARC Electric Cooperative highlighted the high demand for their services by touting a survey conclud-

449. Darrell M. West & Jack Karsten, *Rural and Urban America Divided by Broadband Access*, BROOKINGS (July 18, 2016), <https://www.brookings.edu/blog/techtank/2016/07/18/rural-and-urban-america-divided-by-broadband-access/>.

450. Kim Severson, *Digital Age is Slow to Arrive in Rural America*, N.Y. TIMES (Feb. 17, 2011), <http://www.nytimes.com/2011/02/18/us/18broadband.html> (“‘This is like electricity was,’ said Brian Depew, an assistant director of the Center for Rural Affairs, a nonprofit research group in Lyons, Neb. ‘This is a critical utility.’”).

451. Kang, *supra* note 9.

452. *Id.*

453. See Hannah Trostle, *The Power of Electric Cooperatives: Recommended Article*, INST. FOR LOC. SELF-RELIANCE (June 9, 2017), <https://ilsr.org/the-power-of-electric-cooperatives-recommended-article/>.

454. Kang, *supra* note 9.

455. *Id.*

456. See Johnny Kampis, *Tennessee Internet Providers Wary of Bill Allowing Co-ops to Offer Broadband*, WATCHDOG (Mar. 15, 2017), <http://watchdog.org/290985/tennessee-cooperatives-broadband/>.

457. See Kang, *supra* note 9.

458. *One Pager: Tennessee Broadband Accessibility Act*, TENN. STATE GOV'T, <https://www.tn.gov/nexttennessee/tennessee-broadband-accessibility-act/one-pager—tennessee-broadband-accessibility-act.html> (last visited Oct. 14, 2018).

ing that 60% of its members would subscribe to broadband internet if given the opportunity through the cooperative.⁴⁵⁹ Yet 60% is not that large of a portion. This suggests that even if electric cooperatives expand broadband access, the cost might still outweigh the benefits. This is only one of many issues that currently face cooperatives trying to provide internet services.

B. Barriers to RECs as Internet Providers

Electric cooperatives across the nation face numerous hurdles before they can even begin constructing needed internet infrastructure. For one, many states have simply banned cooperatives from offering internet services.⁴⁶⁰ Until the Tennessee Broadband Act, for example, Tennessee electric cooperatives were forbidden from offering internet services.⁴⁶¹ Even after this legislation, they still face stiff regulation. They cannot offer broadband internet services outside their coverage area without permission from that area's municipality or cooperative,⁴⁶² nor can they use assets gained from electricity services to construct or support broadband internet expansion.⁴⁶³ They also face daunting problems with obtaining needed easements for fiber optic cables—existing easements for electric wires may not cover the new wiring.⁴⁶⁴ In response, some states are considering bills similar to Indiana's Facilitating Internet Broadband Rural Expansion Act (FIBRE), which permits cooperatives to install fiber optic cables along existing electricity easements.⁴⁶⁵ In other states, however, such proposals have died. When the Georgia State Assembly considered a bill similar to Indiana's bill, lobbying prevented it from advancing beyond committee.⁴⁶⁶

In addition to regulatory burdens, another obstacle, likely the most formidable, is the immense cost associated with expanding broadband internet access. The cost to build out fiber optic cable lines to every house-

459. Craig Settles, *High-Profile Examples Put the Focus on Co-ops and Broadband*, DAILY YONDER (May 3, 2017), <https://www.dailyyonder.com/high-profile-examples-put-focus-co-ops-broadband/2017/05/03/19211/>.

460. Inst. for Local Self Reliance, *Community Broadband Preemption Sheet*, COMMUNITY NETWORKS, <https://muninetworks.org/sites/www.muninetworks.org/files/2page-comty-bb.pdf> (last visited Oct. 14, 2018).

461. *H.B. 0529 Bill Summary*, TENN. GEN. ASSEMBLY (2017), <http://wapp.capitol.tn.gov/apps/BillInfo/Default.aspx?BillNumber=HB0529> (select "Summary").

462. *Id.*

463. *Id.*

464. *See Bill Digest, S.B. 478*, IND. GEN. ASSEMBLY (2017), <https://iga.in.gov/legislative/2017/bills/senate/478>.

465. *Id.*

466. *S.B. 232, 154th Gen. Assemb., Reg. Sess.* (Ga. 2017), <http://www.legis.ga.gov/Legislation/en-US/display/20172018/SB/232>.

hold would likely be several hundred billion dollars.⁴⁶⁷ In Tennessee, it has been estimated that building a comprehensive fiber optic network in rural communities that followed federal internet speed guidelines would cost \$1.1–\$1.7 billion.⁴⁶⁸ While other measures could be taken to reduce the cost, such as building out a wireless network, this just shows the staggering cost that electric cooperatives and their members would face if they took it as a goal to provide broadband internet.

C. *The Need for Federal Intervention*

Whether states promote fiber optic cable networks or advance wireless services as a method for expanding internet access to rural areas, the amount of money that it will take to expand these services seems likely to vastly exceed the resources available at the state or local level. Simply put, RECs will need assistance from the federal government to fund expansion of internet service, much as they needed federal loans to expand electric service eighty years ago. Even states, such as Tennessee, that are enthusiastic about expanding service probably cannot pay for it. There is clearly a pressing need for rural broadband; one study found that, while only 2% of Tennessee's urban residents do not have access to FCC grade broadband internet (25 mbps download/3 mbps upload), 34% of rural residents lack it.⁴⁶⁹ In response, the Tennessee Broadband Act created a \$30 million grant program to incentivize internet providers to expand access to rural communities and a \$15 million tax credit program to assist the purchase of broadband equipment for communities. But this is simply not enough to accomplish the task. One state representative estimated that it would take the cooperatives located in one county approximately \$150 million to expand fiber optics throughout their region.⁴⁷⁰ Fully building out a fiber optic network to every home in the state now without it would cost over \$1 billion.⁴⁷¹

Funding this type of project will undoubtedly require federal intervention and subsidies. While it is likely to be politically popular to expand the

467. Levitz & Bauerlein, *supra* note 8, at A1 (“Delivering up-to-date broadband service to distant reaches of the U.S. would cost hundreds of billions of dollars.”).

468. Strategic Networks Group & NEO Connect, *TNECD Broadband Initiative Summary* at 2 (July 19, 2016), <https://www.tnecd.com/files/415/broadband-study.pdf>.

469. Strategic Networks Group & NEO Connect, *Internet Connectivity and Utilization in Tennessee*, DEP'T OF ECON. & COMMUNITY DEV. 4 (June 2016), <https://www.tnecd.com/files/415/broadband-study.pdf>.

470. See Online Recording, Business and Utilities Committee Meeting, held by the Tennessee General Assembly (Mar. 22, 2017, 21:50-22:10), <http://wapp.capitol.tn.gov/apps/BillInfo/Default.aspx?BillNumber=HB0529> (select “Video,” then scroll to select the “Video” link for the March 22 Business and Utilities Committee meeting) (comments of Representative Pat Marsh concerning Bedford County, TN).

471. Strategic Networks Group & NEO Connect, *supra* note 468, at 2.

federal government's involvement in this area, and to offer low cost loans or grants to RECs, it is important to remember that RECs will continue to suffer from the same, or worse, governance problems that they have today if we expand their role to the provision of rural internet services and make no other changes. If massive federal subsidies are going to be provided to encourage REC involvement, we believe such subsidies must be accompanied by action to address the separation of ownership and control at RECs.

As discussed earlier, the changes needed to create an enhanced market for corporate control of RECs seem unlikely. In the absence of market forces, an alternative form of monitoring will need to be created. Reinvigorating RUS would be a good first step. But the reinvigorated agency will likely have to go far beyond what REA did in the 1930s. Then, REA supervision and correction of RECs did not appear sufficient to root out governance problems, even in decades where REA staff were deeply involved in the organization, construction, and operation of cooperatives, and when they were still in the early, idealistic years of the New Deal and the rural electrification movement. We suggest, at minimum, sharply expanded reporting and auditing of RECs, far greater transparency concerning financial and operational data about individual RECs, and perhaps even incorporation of some of the corporate governance reforms implemented with public corporations in the Sarbanes–Oxley and Dodd–Frank Acts and implementing them in REC governance.

V. CONCLUSIONS AND POLICY IMPLICATIONS

In this Article we have examined the career of RECs. They came to prominence in the heady days of the New Deal as a way to bring electric power to rural America. The choice to distribute power through RECs was more political than economic, dictated mostly by the political battles that shaped the electrical industry in that era. While many advocates of rural improvement embraced cooperatives as a form uniquely suited not only to bring power to rural Americans but also to train them in habits of democratic participation, RECs fell short of their hopes. From the beginning, RECs were plagued by the problems created by the separation of ownership and control, and as shown, they have carried those problems into the present day. In the twenty-first century, RECs are still marked by powerful management and apathetic owners, which enables a range of dysfunctions in their operations.

Having identified these problems, we offer two potential solutions. First, we argue for legal changes that would give rise to a vigorous market for corporate control of RECs, a market that is almost completely blocked by current law. This market, we believe, would function much as it does with private corporations, leading private investors to identify and target

under-performing RECs and, through takeovers, eventually improve their economic performance to the benefit of member-customers. Alternatively, we suggest that RECs take up a new public task of providing broadband internet service to their regions, with funding to be provided by the federal government. In return, we believe the RECs' regulator should, with new energy, engage in vigorous oversight of RECs. Decades after the corporate governance revolution has addressed the separation of ownership and control at public corporations, it is time for that separation and its accompanying pathologies to be addressed with RECs.

APPENDIX

Illustration 1: East Kentucky Power Co-op (EKPC) for 2015 & 2016A. *Balance Sheets (year ending Dec. 31)*
(dollars in thousands)

Assets	2016	2015
<u>Electric plant</u>		
In-service	\$4,043,504	\$3,948,438
Construction-in-progress	34,114	50,876
	4,077,618	3,999,314
Less accumulated depreciation	1,319,126	1,217,768
Electric plant - net	2,758,492	2,781,546
Long-term accounts receivable	1,225	1,364
Restricted cash and investments	232,176	7,063
<u>Investment securities</u>		
Available-for-sale	33,735	35,271
Held-to-maturity	8,397	8,488
<u>Current assets</u>		
Cash and cash equivalents	124,116	51,473
Restricted investment	174,749	62,195
Accounts receivable	89,231	74,324
Fuel	47,392	71,527
Materials and supplies	61,112	57,209
Regulatory assets	863	2,529
Other current assets	6,563	6,840
Total current assets	504,026	326,097
Regulatory assets	168,958	162,262
Deferred charges	3,170	1,494
Other noncurrent assets	8,054	7,168
Total assets	\$ 3,718,233	\$3,330,753
<u>Members' equities and liabilities</u>		
Members' equities:		
Memberships	\$ 2	\$ 2
Patronage and donated capital	588,897	535,189
Accumulated other comprehensive loss	(13,074)	(23,244)
Total members' equities	575,825	511,947

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Long-term debt	2,794,578	2,499,815
<u>Current liabilities</u>		
Current portion of long-term debt	89,650	91,661
Accounts payable	66,170	62,770
Accrued expenses	38,973	14,579
Regulatory liabilities	1,759	1,077
Total current liabilities	196,552	170,087
Accrued postretirement benefit cost	83,159	88,530
Asset retirement obligations and other liabilities	68,119	60,374
Total members' equities and liabilities	3,718,233	3,330,753

B. Statements of Revenue and Expenses and Comprehensive Margin
(year ending Dec. 31)
(dollars in thousands)

	2016	2015
Operating revenue	\$887,419	\$885,054
<u>Operating expenses:</u>		
Production:		
Fuel	247,040	228,372
Other	151,105	149,553
Purchased power	114,954	147,354
Transmission and distribution	55,866	53,395
Regional market operations	4,524	4,366
Depreciation	106,366	95,164
General and administrative	57,276	52,105
Total operating expenses	737,131	730,309
<u>Fixed charges and other:</u>		
Interest expense on long-term debt	113,042	113,259
Amortization of debt expense	458	440
Accretion and other	314	(74)
Total fixed charges and other expenses	113,814	13,625
Operating margin	36,474	41,120
<u>Nonoperating margin:</u>		
Interest income	17,233	8,974
Patronage capital allocations from other co-operatives	194	230
Regulatory settlements	(20)	0
Other	(173)	0
Total nonoperating margin	17,234	8,170
Net margin	53,708	49,290
Other comprehensive margin (loss):		
Unrealized loss on available-for-sale securities	(42)	(72)
Postretirement benefit	10,212	1,824)
Obligation gain (loss)	10,170	(19,896)
Comprehensive margin	<u>\$63,878</u>	<u>\$29,394</u>

Illustration 2: Volunteer Energy CooperativeA. *Balance Sheet (as of June 30, 2015)*

Assets	
Electric plant in service	\$417,944,487
Less Depreciation	186,001,917
Total	231,942,570
Other property and Investments	5,474,810
<u>Current and accrued assets:</u>	
Cash and Temporary Cash investments	29,832,083
Accounts receivable	22,236,382
Materials and supplies	2,924,669
Prepayments	0
Other current assets	1,388,145
Total	56,381,279
Deferred debits	
Receivables-conservation	5,870,857
Other deferred debits	1,012,060
Total	6,882,917
Total Assets	<u>300,681,577</u>
Capital and Liabilities	
<u>Capital:</u>	
Membership certificates	434,580
Earnings reinvested in system assets	<u>226,926,116</u>
Total	227,360,696
Long-term debt	27,030,686
Other noncurrent liabilities	9,135,205
<u>Current and Accrued liabilities:</u>	
Other notes payable	0
Accounts payable	18,202,393
Customer deposits	4,718,855
Taxes and interest	1,160,615
Other current liabilities	805,358
Total	24,887,221
Deferred credits	12,267,769
Total Capital and Liabilities	<u>300,681,577</u>

B. Statements of Income and Earnings Reinvested in System Assets (fiscal year ended June 30, 2015)

Operating Revenue	
<u>Sale of electric energy:</u>	
Residential	\$150,342,751
Commercial	23,232,676
Industrial	58,383,387
Street and other lighting	4,085,196
Total sale of electric energy	236,044,010
Other revenue	5,619,838
Total operating revenue	241,663,848
Operating Expenses	
Cost of power purchased from TVA	191,441,614
Distribution and transmission expense	16,076,513
Customer accounts expense	3,882,303
Customer service, sales, and Information expense	488,824
Administrative and general expense	7,901,892
Depreciation	14,401,800
Taxes	2,916,013
Interest expense	1,646,546
Total operating expense and interest	234,988,020
Operating Income	6,675,828
Other income	1,135,754
Net Income	<u>7,811,582</u>
Earnings Reinvested in System Assets	
Beginning of fiscal year	219,114,534
End of fiscal year	226,926,116