

Alert

A Look at Four Recent Electrical Cooperatives in Bankruptcy — Context to *Brazos Electric*

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Brazos Electric Power Cooperative recently filed for Chapter 11 relief in the U.S. Bankruptcy Court for the Southern District of Texas, weeks after the February ice storm severely disrupted Texas's electricity supply and prices. Brazos filed for bankruptcy in part to shield its member cooperatives and consumers from liability for invoices totaling over \$2.1 billion from the Electric Reliability Council of Texas.

In contemplating what Brazos's Chapter 11 filing means for its creditors, we have looked at relatively recent electrical cooperative Chapter 11 bankruptcies to help outline the range of potential outcomes in *Brazos Electric*. Of those four cases, three led to the ultimate sale of the coop's assets to an outside purchaser, though using differing mechanisms. A fourth case largely reinstated the existing structure after reducing debt load.

In short, the assets of Brazos may be in play in its bankruptcy — despite the potential statutory restrictions under Texas state law that could limit ownership of Brazos to its coop members.

Key points we will discuss further in this *Alert* include:

- Creditors should be aware of how relevant state law restricts the transfer of membership in electric cooperatives. For example, in Texas, membership in electric coops cannot be transferred.
- Section 363 asset sales in bankruptcy pose many benefits to creditors hoping to take control of a bankrupt electric coop. A coop's assets can be sold free and clear of all liens, interests and other encumbrances to a creditor, without running afoul of any laws prohibiting membership transfers. Courts also typically permit creditors to credit bid at these auctions.
- Creditors have also utilized trusts to gain control over an electric coop post-bankruptcy. These trusts have enabled coops to maintain technical ownership of their assets, while permitting creditors to control any transfer post-bankruptcy.
- Electric coop bankruptcies present more potential conflict of interest and fiduciary duty concerns than typical Chapter 11 cases. This is because a bankrupt coop's members are often other coops who have fiduciary duties to both their own members and customers, as well as the debtor coop. As a result, courts have appointed trustees in several recent cases.

Overview of Recent Electrical Cooperative Cases

Colorado-Ute Electric Association

Colorado-Ute filed for bankruptcy on March 30, 1990. Prior to filing, Ute paid over \$3.3 million in fees relating to merger discussions with Tri-State Electric. Ute officers admitted that one firm it hired “was overpaid.” They also transferred millions from a Colorado trust to a Texas bank “to make it more difficult for the creditors to locate the money and attach a lien.” *In re Colo. Ute Elec. Ass’n Inc.*, 120 B.R. 164, 170-73 (Bankr. D. Colo. 1990).

The Court appointed a trustee upon a motion from creditors alleging “gross mismanagement and incompetence” of the officers, finding the conflicts “between and among [Ute] and its directors formidable” and doubting management could effectively reorganize the debtor.

Ultimately, the Court confirmed a plan in which three external utilities (PacifiCorp, Public Service Co. of Colorado, and Tri-State) each purchased a portion of Ute’s generating and transmission assets. The plan also permitted Ute’s coop members to decide which entity to join. Ten of Ute’s 14 members became members of Tri-State, which obtained a significant ownership stake in Ute’s power plant.

Cajun Electric Cooperative

Cajun Electric Power Cooperative filed for Chapter 11 relief in 1994 in the Middle District Of Louisiana. Cajun was an electric generation and transmission cooperative in Louisiana with twelve members, which owned two fossil-fueled generating plants and a 30% interest in River Bend nuclear plant.

The Court appointed a trustee after noting that conflicts within the Debtor’s Board made it “impossible for the debtor-in-possession to act as a fiduciary for the estate at the same time as it acts as a fiduciary for its members and customers.” The U.S. Bankruptcy Court for the Middle District of Louisiana confirmed a plan incorporating an asset purchase agreement and settlement agreement. Under the asset purchase agreement, a subsidiary of NRG Energy Inc. acquired substantially all of Cajun’s non-nuclear assets — including the two fossil-fueled generating plants.

Additionally, under the settlement agreement, Rural Utilities Service, a pre-bankruptcy lender secured by Cajun’s interest in River Bend, succeeded to Cajun’s interest in the River Bend nuclear plant with the option to retain it, sell it or force Cajun’s second largest creditor and co-owner of the plant, Gulf States Utilities Co., to take it. Proceeds from any asset sales were to be distributed to creditors. *In re Cajun Elec. Power Coop. Inc.*, No. 94-11474, PACER ECF No. 5636 (Bankr. M.D. La. Oct. 14, 1999); *Official Comm. Of Unsecured Creditors v. Cajun Elec. Power Coop. Inc.*, 119 F.2d 349 (5th Cir. 1997).

Naknek Electrical Association Inc.

Naknek Electric Association Inc. filed a chapter 11 petition in 2010, maintaining operations during the proceeding.

Three years later, the Alaska Bankruptcy Court confirmed a plan providing that all of Naknek’s assets and rights would revert in a reorganized Naknek. Under the plan, the senior secured noteholders’ loans remained outstanding. Also under the plan, Naknek dedicated a portion of the utility rates it recovered from its members over a 20-year period to satisfy its unsecured creditors’ claims. Unsecured creditors could elect to receive a one-time payment by Aug. 31, 2014.

Southern Montana Electric Generation Cooperative

Southern Montana Electric Cooperative filed for Chapter 11 relief in 2011, and the Court appointed a trustee due to conflicts within the Member-controlled Board. Southern Montana's prepetition noteholders held a lien against the Highwood Generating Station, which was Southern Montana's primary asset. Under the plan, the Debtors maintained equity ownership of the generating station. However, the plan created a new trust that would control all decisions related to the disposition of the generating station and benefit from the proceeds of any disposition. The HGS Holding Trust was formed for the benefit of the Noteholders as beneficiaries.

The plan mandated that the Trust consult with the Noteholders regarding any decisions that would affect their interests, including whether to sell HGS. After the bankruptcy, the Trust later sold the generating station to ProEnergy Solutions. This structure enabled the noteholders to control and benefit from the sale of the generating assets without ever assuming control over those assets, which was likely prohibited under state law. See *In re S. Mont. Elec. Generation & Transmission Coop. Inc.*, No. 11-62031-11, PACER ECF No. 1463 (Bankr. D. Mont. June 22, 2014).

Takeaways

- Because Brazos's bankruptcy case is pending in Texas, it's important to understand how Texas state law restricts ownership of electrical coops. Only members of an electric coop may own the coop. See 7 U.S.C. § 1732(4). Texas law further restricts transfer of those ownership interests. See V.T.C.A., Utilities Code § 161.065(c) ("Membership in an electric cooperative is not transferable."). Thus, creditors must consider creative solutions if they seek to control or purchase those assets from Texas-based electric coops.
- Potential solutions could include a sale process, credit bidding and more creative solutions such as trust arrangements. The Southern Montana case suggests that electric cooperatives are willing to explore creative strategies involving trusts that control decisions to sell assets, while abiding by state law by maintaining asset ownership with the coop itself.
- Electric cooperatives may be susceptible to conflicts of interest or financial mismanagement requiring court-appointed trustees. Southern Montana and Ute both experienced deadlock among the members that necessitated trustees. Cajun Electric members faced conflicting fiduciary duties — one to their own customers and the other to the cooperative's Board — making it impossible to fulfill either obligation without the intervention of a trustee. Because electric cooperative members are often other electric cooperatives, we expect dual conflicts of interests to be a recurring issue in these restructuring cases. If Brazos's board has significant internal conflicts, or if there are competing financial interests between Brazos and its member cooperatives, creditors should consider requesting appointment of a trustee.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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