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BEFORE THE ARIZONA CORPORATION COMMISSION

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ARIZONA CORPORATION COMMISSION
STAFF CONTROL

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IN THE MATTER OF THE APPLICATION OF
ADAMAN MUTUAL WATER COMPANY
FOR APPROVAL TO ISSUE STOCK.

DOCKET NO. W-01997A-09-0297

STAFF'S POST HEARING BRIEF

I. INTRODUCTION.

On June 4, 2009, Adaman Mutual Water Company ("Adaman" or "Company") filed a request for approval to issue stock as part of its plan to reorganize from a nonprofit corporation into a for-profit corporation. The purpose for the reorganization is to enable Adaman to sell bulk water to the City of Goodyear ("City"). On June 12, 2009, the Company filed its first Amended Application. Subsequently, Arizona Corporation Commission ("Commission") Utilities Division Staff ("Staff") filed its Staff Report on February 5, 2010 wherein Staff recommended approval of the issuance of stock as requested, but recommended against the Commission approving the plan of reorganization. The Company filed comments to the Staff Report and additionally filed a further Motion to Amend Application on March 22, 2010 which expanded the requested relief to include, among other things, approval of a bulk water rate. In response to the changes to the relief requested by Adaman, Staff provided a Supplemental Staff Report on April 14, 2010 recommending approval of the bulk water rate, deferral of the income and expenses related to bulk water sales using the recommended rate pending a full rate case, and the issuance of stock. However, Staff continued to recommend against approving the plan of reorganization as well as approval of the bulk water sales agreement between Adaman and the City.

At the close of the evidentiary hearing that took place on August 17, 2010 in the above captioned matter, parties were ordered to brief several specific issues. These issues included whether Adaman will remain a fit and proper entity to hold a Certificate of Convenience and Necessity

1 (“CC&N”) following the transition to for-profit status; what authority provides that a nonprofit
2 corporation can reorganize as a for-profit; whether Arizona Revised Statute (“A.R.S.”) §10-1001
3 amendments to articles of incorporation encompasses wholesale reorganization of a nonprofit
4 corporation; the appropriateness of a delay in the issuance of stock requested by Adaman in order to
5 obtain a letter ruling from the Internal Revenue Service (“I.R.S.”); and the distribution of assets upon
6 dissolution following the condemnation. Staff hereby provides its closing brief on these issues.

7 **II. DISCUSSION.**

8 **A. Will Adaman Be Fit And Proper To Hold A CC&N As A For-Profit Corporation.**

9 As Staff argued in closing, the Company will be at least equally fit and proper, if not more fit
10 and proper, to hold a CC&N following the reorganization into a for-profit corporation as it is
11 presently as a nonprofit. Staff would note that “Fit and Proper” is not a statutory standard so much as
12 regulatory recognition that the CC&N applicant or holder is appropriate to have the CC&N.¹ The
13 relevant CC&N provisions are set out at A.R.S. § 40-281 *et seq.* and make no reference to fitness and
14 properness. Rather, a close examination of A.R.S. § 40-281 *et seq.* reveals the substantial discretion
15 the Commission retains in its evaluation of whether it is appropriate to extend a CC&N to a utility.
16 For example, A.R.S. § 40-282(C) provides that the Commission *may* issue or refuse to issue a CC&N
17 and *may* issue the CC&N subject to such conditions as it deems appropriate under the circumstances.

18 As it relates to the CC&N approval process, the fit and proper standard is used more as a
19 conclusory statement by the Commission that the CC&N applicant is an appropriate provider of the
20 certificated service. Generally, the analysis considers whether the CC&N applicant or holder has
21 demonstrated the competence in terms of technical, financial, managerial and compliance/customer
22 service to provide the certificated service. *See e.g.* Decision No. 66984 (May 11, 2004) (consolidated
23 CC&N applications and deletions by telecom that were contested on the basis that the applicant was
24 not fit and proper). *See also James P. Paul Water Co. v. Ariz. Corp. Comm’n*, 137 Ariz. 426; 671
25 P.2d 404 (1983) (prior to deleting an existing utility’s CC&N in favor of a competing utility, the
26

27 ¹ In Staff’s research, the only statutory reference to “fit and proper” in relation to public service companies is
28 A.R.S. § 40-607 (common motor carrier CC&N) prior to its repeal in 1979.

1 CC&N holder subject to potential deletion must be given an opportunity to demonstrate it is able and
2 willing to provide adequate service at reasonable rates.)

3 Staff believes that the Company will continue to be a suitable CC&N holder after the
4 reorganization as a for-profit. Staff is unaware of any outstanding compliance issues. The only
5 major compliance matter that was an issue for the Company related to its arsenic contaminant levels
6 and for which it had an Environmental Protection Agency (“EPA”) exemption. That exemption has
7 since been released now that the Company has adequate treatment to reduce its contaminant levels.
8 Tr. at 117:18-22 Likewise, the only customer service issues related to the Company that have been
9 discussed in the present application relate to the control issues between the customer/members and
10 the Company’s Board. These are not the variety of customer service issues that would ordinarily
11 suggest that a utility is not fit and proper such as consistently improper billing and failure to make
12 ordinary service repairs for example.

13 The evidence in this record suggests that the Company’s financial ability to provide an
14 adequate level of service will only be improved by the conversion to a for-profit status. The
15 underlying purpose of the application is to place the Company in a position where it can make bulk
16 water sales to the City. The revenues from the anticipated sales are so significant that Adaman would
17 lose its tax-exempt nonprofit status. Tr. at 62:5-8, 152:9-17, 235:11-22. This will improve the
18 Company’s financial strength, not merely by adding a significant influx of revenue, but also by
19 having a large customer able to help buoy the Company’s cost of service.

20 Further, as a result of the bulk water sales agreement with the City, Adaman will receive an
21 arsenic treatment facility that the record reflects the Company would not have been able to construct
22 with its current level of revenues. Tr. at 150:20-151:5. As the testimony of Company witness
23 Schofield explained, Adaman’s water was between 11 and 16 parts per billion (“ppb”) arsenic
24 contamination which is in excess of the 10 ppb limit established by the EPA pursuant to the Safe
25 Drinking Water Act of 1974 (42 U.S.C. §§300f– 300j). Tr. at 117:16-18. Since the effective date of
26 the requirement, Adaman continued to provide water pursuant to an exemption provided by the EPA.
27 *Id.* at 117:18-19. With the construction of the arsenic treatment facility that is made possible by the
28 bulk water sales agreement, and necessarily the reorganization as a for-profit corporation, the

1 Company will be in compliance with the EPA's arsenic contaminant standard. *Id.* at 117:19-22.
2 Further, the record makes clear that the Company would have had significant financial difficulty
3 obtaining comparable arsenic treatment by its own means. Tr. at 150:20-151:5. As such, Adaman's
4 technical ability to provide drinking water service will improve from its current abilities as a
5 nonprofit. Therefore Staff believes that Adaman will be no less fit and proper to hold a CC&N as a
6 for-profit than it is presently as a nonprofit.

7 **B. Can A Nonprofit Reorganize As A For-Profit And Can It Do So Pursuant To**
8 **A.R.S. §§ 10-1001 (Or 10-11001) (Amendments To Articles Of Incorporation).**

9 In the original Staff Report that was docketed on February 5, 2010, Staff indicated under the
10 section titled "Reorganization Analysis" that the appropriate statutory authority for the reorganization
11 is A.R.S. § 10-1001 and -1003. Exhibit S-2 at 2. Staff would hereby clarify that Adaman is a
12 nonprofit corporation and as such A.R.S. § 10-1001 and -1003, governing the articles of amendment
13 for for-profit corporations, do not apply. Rather, the pertinent statutes are A.R.S. § 10-11001 and -
14 11003. A.R.S. § 10-11001(A) provides that a "corporation may amend its articles of incorporation at
15 any time to add or change a provision that is required or permitted in the articles of incorporation or
16 to delete a provision that is not required or permitted in the articles of incorporation." Likewise,
17 A.R.S. § 10-11003(A)(1) states that a "corporation's board of directors may propose one or more
18 amendments to the articles of incorporation for submission to the members."

19 Staff believes that corporations are permitted to effect reorganizations through amendments to
20 the articles of incorporation rather than necessarily dissolving and reincorporating. The Arizona
21 Attorney General explained that:

22 Corporations may and sometimes do, effect their own reorganization and this without
23 being reincorporated. This may properly be accomplished by an amendment to the
Corporate Charter properly approved by the requisite vote of the stockholders.

24 Atty. Gen. Op. 62-55-L (1962) citing 19 C.J.S. §1584. Although dated, the analysis and conclusion
25 reached by the Attorney General still holds true today. A.R.S. § 10-11001(A) provides that a
26 nonprofit corporation "may amend its articles of incorporation at any time to add or change a
27 provision that is required or permitted in the articles of incorporation or to delete a provision that is
28 not required in the articles of incorporation." There are no limitations on the scope of the additions or

1 changes. Likewise, the determination whether the change was appropriate, i.e. whether it was
2 required or permitted by the articles of incorporation is determined as of the effective date of the
3 amendment. A.R.S. § 10-11001(A). Consequently, a nonprofit corporation may, by amendment,
4 give itself the authority to render the changes necessary to perform the actions of a for-profit
5 corporation and in so doing become a for-profit corporation.

6 Though cases directly on point are sparse in Arizona, caselaw supports the proposition that
7 reorganizations may be effected by amendments to articles of incorporation. *See e.g. White v.*
8 *Wogaman* 47 Ariz. 195, 54 P.2d 793 (Ariz. 1936) (general corporation reorganized by amendment to
9 articles of incorporation to become a building and loan association once statute recognized building
10 and loan associations as distinct business forms). In other jurisdictions it appears to be a relatively
11 unextraordinary means to effect a reorganization as well. *See e.g. Blue Cross and Blue Shield of*
12 *Missouri v. Nixon* 81 S.W.3d 546 (Mo.App. W.D.,2002) (company used articles of amendment to
13 reorganize when state law changed to mandate that nonprofit corporations be classified either as
14 mutual benefit or public benefit); *Furman v. C.I.R.* T.C. Memo. 1998-157, 1998 WL 209265
15 (U.S.Tax Ct.,1998) (articles of amendment used to reorganize for 26 U.S.C. § 368 (a)(1)(E) income
16 tax purposes).

17 Other current Arizona statutes clearly anticipate that the means to effectuate a reorganization
18 is by means of articles of amendment. For example, in the event that a court orders that the
19 corporation implement a plan of reorganization that would require an amendment of its articles in
20 order to effectuate, A.R.S. § 10-11008(A) permits such amendment even without the approval of the
21 board of directors or members.

22 As stated in the hearing, Staff recognizes that there are other ways to perform a
23 reorganization, including reincorporation. Tr. 276:16-277:5. However, it appears to Staff that it is
24 possible to perform a reorganization by means of amending its articles of incorporation.

25 **C. Appropriateness Of Delaying The Issuance Of Stock Pending A Letter Ruling**
26 **From The I.R.S.**

27 Dr. LaBarre introduced the possibility of delaying the approval for the Company to issue
28 stock pending a Private Letter Ruling (“PLR”) from the I.R.S. that confirms that the Company’s

1 proposed reorganization can proceed tax-free. Tr. at 234:15-235:1. In support of the proposition that
2 obtaining a PLR is appropriate, Dr. LaBarre submitted an affidavit of her communications with a
3 representative of the I.R.S. Exhibit I-1. Notably, in Dr. LaBarre's affidavit the matters raised with
4 the I.R.S. representative that prompted the recommendation to obtain a PLR related to the issues of
5 "de-mutualization' and the creation of Preferred Shares by the new Company." *Id.* Dr. LaBarre
6 believes that obtaining a letter ruling is a viable way to proceed because it will eliminate concerns
7 about tax consequences related to the reorganization and that it should not take more than a few
8 months to obtain. Tr. at 272:9-12.

9 The procedures governing the issuance of I.R.S. PLRs are provided at Rev. Proc. 2009-1. Per
10 Rev. Proc. 2009-1, a Letter Ruling is:

11 [A] written determination issued to a taxpayer by an Associate office in response to
12 the taxpayer's written inquiry, filed prior to the filing of returns or reports that are
13 required by the tax laws, about its status for tax purposes or the tax effects of its acts
14 or transactions. A letter ruling interprets the tax laws and applies them to the
15 taxpayer's specific set of facts. A letter ruling is issued when appropriate in the
16 interest of sound tax administration. One type of letter ruling is an Associate Office's
17 response granting or denying a request for a change in a taxpayer's method of
accounting or accounting period. Once issued, a letter ruling may be revoked or
modified for a number of reasons. *See* sections 11 and 9.19 of this revenue procedure.
A letter ruling may be issued with a closing agreement, however, and a closing
agreement is final unless fraud, malfeasance, or misrepresentation of a material fact
can be shown. *See* section 2.02 of this revenue procedure.

18 Rev. Proc. 2009-1 Section 2.01. Taxpayers may request letter rulings on issues related to
19 reorganizations. Rev. Proc. 2009-1 Section 3.01. Further, "a corporate taxpayer could request a
20 letter ruling that solely addressed the tax consequences to its shareholders of a proposed
21 reorganization." Rev. Proc. 2009-1 Section 6.06. However, the I.R.S. generally will not issue
22 "comfort" letter rulings where an issue is "clearly and adequately addressed by statute, regulations,
23 decisions of a court, revenue rulings, revenue procedures, notices, or other authority published in the
24 Internal Revenue Bulletin." Rev. Proc. 2009-1 Section 6.11. Nor will the I.R.S. issue a letter ruling
25 with regard to issues that are not actually presented by the facts of the situation i.e. hypotheticals.
26 Rev. Proc. 2009-1 Section 6.12.

27 The pertinent tax code provisions relating to reorganizations can be found in Title 26 of the
28 United States Code Annotated ("U.S.C.A."). Per 26 U.S.C.A. § 368(a)(1)(E), a reorganization

1 includes a recapitalization such as the present instance where members' equity is being exchanged for
2 stock. The reorganization that Adaman is proposing would convert the entity from a nonprofit
3 corporation into a for-profit corporation and would qualify as a reorganization under the statute.

4 Pursuant to 26 U.S.C.A. § 354(a)(1):

5 No gain or loss shall be recognized if stock or securities in a corporation a party to a
6 reorganization are, in pursuance of the plan of reorganization, exchanged solely for
7 stock or securities in such corporation or in another corporation a party to the
reorganization.

8 However, under 26 U.S.C.A. § 354(a)(2)(A), existing stock must be surrendered if new stock is
9 received and the stock obtained as part of a plan of reorganization must have the same principal value
10 as the stock surrendered.² Consequently, the tax statute provides that there are no tax consequences
11 to a stock for stock exchange that is performed pursuant to a plan of reorganization in order to effect
12 the reorganization.

13 Staff does not believe that delaying the requested approval to solicit a PLR serves the public
14 interest in this instance. The tax code provisions relating to the tax-free nature of the reorganization
15 under the circumstances described by Exhibits A-1 and A-2 are unambiguous that the reorganization
16 would recognize no gain or loss. 26 U.S.C.A. § 354(a)(1). In other words, the transaction will be
17 tax-free. The I.R.S. prohibition against issuing "comfort" letter rulings would appear to bar the
18 issuance of a PLR under these circumstances. Rev. Proc. 2009-1 Section 6.11.

19 To the extent that a representative from the I.R.S. appears to have recommended that the
20 Company request a letter ruling as described in Exhibit I-1, the recommendation appears to stem
21 from a concern with "'de-mutualization' and the creation of Preferred Shares by the new Company."
22 The exchange of common stock on a proportional basis to acres owned for the elimination of the
23 previous ownership interests preserves the mutual nature of the transaction. Tr. at 64:4-6, 156:2-7;
24 Exhibit A-1 at 3:23-28. Likewise, the record has been absolutely clear that there are no Preferred
25 Shares being created as part of the reorganization. Exhibit A-1 at 3:19-20. Rather, the Company will
26 have the ability in the future to issue Preferred Shares upon receiving Commission approval. Exhibit
27

28 ² In the present application, the Company is treating the acreage-based ownership interest in Adaman as an
approximation for existing stock ownership. Tr. at 35:7-23.

1 A-16, attached Amended and Restated Articles of Incorporation of Adaman Mutual Water Company
2 at Article 4. Preferred Shares are a non-issue with regard to the reorganization of Adaman and as
3 such, requesting a PLR on that issue would be tantamount to requesting a letter ruling on a
4 hypothetical which is prohibited per Rev. Proc. 2009-1 Section 6.12.

5 Continued delay of the Company's requested issuance of stock prevents its ability to perform
6 for-profit activities, including the sale of bulk water to the City of Goodyear. The addition of a
7 customer the magnitude of City of Goodyear to Adaman will be greatly beneficial for the Company's
8 ratepayers. Therefore, Staff recommends against delaying the approval of Adaman's request to issue
9 stock pending the issuance of a PLR by the I.R.S.

10 **D. Distribution Of Assets Upon Dissolution Following Condemnation.**

11 An issue has been raised regarding the distribution of assets following the dissolution of a
12 Nonprofit following condemnation. The source of the issue appears to be a statement made within
13 two Company produced Question and Answer memoranda. Exhibit A-14, A-15; Tr. at 94:10-20.
14 Specifically, Adaman produced a memorandum that was distributed to the members that explained as
15 a basis for the request to reorganize as a for-profit corporation that:

16 Q1: What are the reasons the Board has recommended changing the Company from
17 a nonprofit corporation to a for-profit corporation?

18 A: As presently organized, the Company cannot make distributions to its
19 Members. The Company can only deliver water to persons located within the
20 Project Area the Company's services. The Company cannot even become a
21 cooperative. **If the Company's water facilities were to be condemned,**
22 **Members would be unable to participate in or benefit from condemnation**
23 **proceeds.** The Company would also be unable to contract with the City of
24 Glendale [sic] to sell excess water. For these reasons, we believe that the
25 change is necessary. **We believe it is possible that at some point in the**
26 **future, the Company's facilities may be condemned and in that event, its**
27 **Members should benefit.**

28 Exhibit A-15 at 1 (emphasis provided).

As currently stated, the Company's articles of incorporation contain no prohibition on
distributions. Per the last amendment to the current articles of incorporation, filed with the
Commission's Corporations Division on August 29, 1994, not only is there no restriction on
distribution of assets upon the dissolution of the Company, that is the procedure that is required.

1 In the event of the dissolution or liquidation of this corporation, the board of directors
2 shall, after paying or making provision for the payment of all the liabilities of the
3 corporation, distribute any and all surplus, capital, or assets thereof to those persons
4 who were members during the period such surplus, capital, or assets were owned by
5 the corporation in proportion to their total payments to the corporation during such
period of time, except to the extent that the portion of such surplus, capital, or assets
attributable to the payments of a former member, whose membership has been sold,
assigned, or otherwise transferred, has previously been paid to such former member.

6 Exhibit A-8 at 6. Further, the current articles of incorporation provide that:

7 Members shall have the right, based upon acres of land or major fractions thereof
8 owned, to (1) elect the directors who shall serve on the board of directors of the
9 corporation, except with respect to filling any vacancy on the board of directors which
10 occurs during the directors' term, (2) receive water and services provided by the
corporation substantially at cost, (3) receive a return of any excess of payments over
losses and expenses, and (4) **share in any surplus, capital, or assets upon
liquidation and dissolution.**

11 *Id.* at 4 (emphasis added).

12 Likewise, there is no prohibition based in Arizona statute that would prevent distributions to
13 members upon the dissolution of the Company. Pursuant to A.R.S. § 10-11302(B), a nonprofit
14 corporation may make distributions in the event of dissolution that are consistent with the
15 requirements of Chapter 37 Dissolution – Nonprofit Corporations. A.R.S. § 10-11405(A)(7) sets out
16 the default rule that the nonprofit corporation continues to exist despite dissolution for the purpose of
17 distributing its assets to its members in the event the corporation has not explicitly placed in its
18 articles of incorporation a provision regarding distribution of assets upon dissolution. Therefore, the
19 Company is not required to reorganize as a for-profit in order to permit distribution to the members of
20 the proceeds from its condemnation and subsequent dissolution.

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1 **III. CONCLUSION.**

2 For all the above stated reasons and those expressed in closing argument at hearing, Staff
3 believes that the application is appropriate, in the public interest and should be granted subject to the
4 recommendations Staff stated in the Staff Report and Supplemental Staff Report.

5 RESPECTFULLY SUBMITTED this 17th day of September, 2010.

6
7 
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