



Mello-Roos may be used to Fund Condemnation Action of Private Utility Provider

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Those of us living in newer neighborhoods are familiar with Mello-Roos – it shows up on our annual tax bills as a way to pay off bonds issued to finance various public improvements, such as schools, streets, and parks that were installed as part of the development of our communities. But can Mello-Roos financing be used for other purposes, such as the acquisition of existing utility services? And can the financing be used to fund an eminent domain action if the local utility service is unwilling to sell its assets?

These issues were recently answered affirmatively by the California Court of Appeal in *Golden State Water Company v. Casitas Municipal Water District* (April 14, 2015). The Court held that not only can Mello-Roos be used to finance a condemnation action, it can also be used to take over local utility providers – including the acquisition of those providers' intangible business assets such as water rights and loss of business goodwill.

The case may open the door to a previously untapped – or at least questionable – method to finance condemnation actions supported by the creation of Communities Facilities Districts, and has the potential for widespread effects.

Background

By way of background, any local agency can use Mello-Roos financing by establishing a Communities Facilities District to finance facilities and services. Subject to approval by two-thirds of the District's voters, the District may then issue bonds to finance facilities and levy and collect a special tax on real property in the District to pay for the bonds or finance the facilities. The Mello-Roos Act allows the district to "finance the purchase, construction, expansion, improvement, or rehabilitation of any real or other tangible property with an estimated useful life of five years or longer"

Apparently unhappy with a variety of factors, residents of Ojai voted to replace their local private water supplier, Golden State Water Company, with a municipal supplier, Casitas Municipal Water District. The residents approved selling \$60 million in Mello-Roos bonds to finance the acquisition of Golden State's water facilities.

Because Golden State was unwilling to sell its business, Casitas planned to use eminent domain to acquire its assets. Golden State filed a petition challenging this plan, arguing that the Mello-Roos Act cannot be used to finance eminent domain actions or to acquire intangible property – such as Golden State's water rights and goodwill. Golden State also argued that the Mello-Roos Act cannot be used by one service provider to supplant another service provider using the same facilities and serving the same customers. The trial court denied each of Golden State's challenges and allowed the financing plan to move forward.

Court of Appeal's Decision

On appeal, after some questionable rhetoric suggesting a bias against investor-owned utilities, the Court first addressed whether a "purchase" of property using Mello-Roos financing requires a voluntary acquisition, or whether Mello-Roos funds can be used for an eminent domain action. The Court held that the word "purchase" in the Mello-Roos Act refers to any acquisition – regardless of whether the acquisition results from a voluntary purchase agreement. The Court explained that because (i) an eminent domain action is effectively a "compulsory purchase" – one in which the public entity must pay the value the owner would receive from a private party in an arm's length transaction, and (ii) the Mello-Roos Act authorizes a public agency to "purchase" real property in order to construct and develop government facilities, the statute should be construed broadly to allow the Mello-Roos Act to finance an eminent domain action.

Next, the Court turned to whether or not the Mello-Roos Act could be used to acquire intangible property rights – such as the private water company's business goodwill. The Court recognized that the Mello-Roos Act is expressly limited to the purchase of "real or other **tangible** property with an estimated useful life of five years or longer" – and therefore cannot be used to purchase intangible property. Nonetheless, the Court held that Mello-Roos financing can be used to acquire intangible property indirectly if the acquisition qualifies as "incidental to, or connected with" the accomplishment of the purpose of the financing. The Court concluded that the acquisition of Golden State's water rights and business goodwill are "closely connected with the acquisition of its facilities for delivering water" and are therefore "incidental expenses" that can be financed under the Mello-Roos Act.

Finally, the Court turned to whether or not Mello-Roos financing can be used to replace one service provider with another, where no additional services are provided. Specifically, Government Code section 53313 provides that Mello-Roos financing can only be used to pay for services "to the extent that they are in addition to those provided in the territory of the district The additional services shall not supplant services already available within that territory." The Court questioned how this provision impacted Casitas' proposed acquisition of Golden State's services, but concluded it could not address the issue because Golden State did not raise the argument at the trial court and, therefore, Golden State had waived the argument.

Conclusion

While the Court upheld Casitas' use of Mello-Roos financing to acquire Golden State's facilities through eminent domain, the battle is likely to continue. Casitas will now likely proceed with a condemnation action,

and we can expect a significant difference in opinions on the value of Golden State's assets. It will also be interesting to see whether Golden State is permitted to pursue a right-to-take challenge in the eventual eminent domain action based on the third factor addressed by the Court, or whether the fact that Golden State did not raise the issue in its petition will be deemed to preclude such an argument.

From a broader perspective, the Court's holding has potentially opened the door to use Mello-Roos financing for a variety of purposes – including the takeover of any private utility service. Finding Golden State's "goodwill" and "water rights" as incidental expenses seems like a stretch depending on the value of these items. What if, for example, the target company's water facilities were worth \$10 million, but its water rights and goodwill (which is essentially the value of the future income stream of customers' payments for its water services) were worth \$100 million? Would those massive intangible assets that dwarf the value of the water facilities truly be "incidental" expenses?

And even if Golden State is not able to pursue its argument under Government Code section 53313 that Mello-Roos financing cannot be used to supplant an existing provider of the same services, other providers will no doubt feature such an argument prominently in any future effort to use Mello-Roos financing to condemn a utility provider's assets.

Private utility providers will be following this case closely, and we'll continue to follow along as the likely condemnation action proceeds.