

ORIGINAL

Decision No. 72500

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application)
of VALLECITO WATER COMPANY, a)
corporation, for an order)
authorizing it to issue and sell)
First Mortgage Series A 6-1/4%)
bonds due July 1, 1986.)

Application No. 48753
(Filed August 26, 1966)
(Amended February 23, 1967)

In the Matter of the Application)
of VALLECITO WATER COMPANY, a)
corporation, for an order)
authorizing it to issue its)
promissory notes.)

Application No. 48754
(Filed August 26, 1966)

William M. Lassleben, Jr. and
Walker Hannon, for applicant.
Brobeck, Pfeleger & Harrison, by
Robert N. Lowry, for San Gabriel
Valley Water Company, interested
party.
Sergius Boikan, staff counsel,
Raymond E. Heytens, and James F.
Haley, for the Commission staff.

O P I N I O N

Vallecito Water Company (Vallecito) seeks authority to issue and sell mortgage bonds in the amount of \$750,000 at 6-1/2 percent interest due March 1, 1987^{1/} so that it may refund past obligations, pay debts, and finance new construction; or, in the alternative to issue promissory notes in the amount of \$225,000. Both applications were consolidated for hearing. San Gabriel Valley Water Company (San Gabriel) appeared as an interested party and opposed both applications on the grounds that the Board of Directors who authorized the filing of these applications had no authority to do so and that the proposed financing was unsound.

1/ Originally Vallecito applied to issue bonds at 6-1/4 percent interest due July 1, 1986. This proposal was changed at the February 23, 1967 hearing to 6-1/2 percent bonds due March 1, 1987.

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Staff counsel appeared in opposition to Vallecito on the legal issues involved.

Public hearings were held October 24 and 25, 1966 at Los Angeles before Examiner Stewart C. Warner and February 23 and 24, 1967 at San Francisco before Commissioner Fred P. Morrissey and Examiner Robert Barnett. The matter was submitted subject to the filing of proposed findings of fact, which have been filed.

A detailed statement of the events that provide background to this case, including a list of the major litigation between Vallecito and San Gabriel, can be found in Decision No. 71795 dated December 30, 1966 in Case No. 8086, and will not be repeated herein.

Who Runs Vallecito?

The responsibility for the operation of a corporation rests with its Board of Directors. (Corp. Code Section 800.) The Board makes policy for the corporation and appoints the officers who carry out this policy and manage the day-to-day affairs of the corporation. The board is elected by the shareholders of the corporation and each director holds his office until his successor is elected. (Corp. Code Section 805.) One of the major issues raised in this case is the validity of the election of the persons who claim to be the present lawful directors of Vallecito. Normally, this Commission would not inquire into the legality of corporate elections - a matter better left in the hands of the Superior Court. But, when orders are made by us affecting a public utility under our jurisdiction we must know the identity of the persons lawfully managing the public utility so that we may know who is responsible for carrying out our orders. Further, corporations are entitled to make applications and file complaints with the Commission.

When the authority of those making application or complaint is challenged an issue is raised as to our jurisdiction over the person of the corporation which we must resolve. (Re Colconda Utilities Co. (1965) 65 CPUC 49, 51; Public Utilities Code Section 701.) Obviously, strangers cannot come before us in the name of a public utility corporation and obtain an order that would bind the corporation.

The facts upon which a determination can be made as to the authority of those purporting to act for Vallecito are found to be as follows:

1. In Decision No. 67261, of which we take official notice, we found, among other things, that:

"Suburban obtained a loan from Security First National Bank-Whittier Branch, in May, 1963; at least \$279,600 of the proceeds of said loan were then loaned to Cal Fin, a wholly owned subsidiary of Suburban; Cal Fin's officers and directors are interlocking and for the purposes of this proceeding Cal Fin is the alter ego of Suburban. Cal Fin purchased or caused to be purchased Vallecito stock with said funds for the purpose of preventing the majority of Vallecito stock from being sold to San Gabriel Water Company's president, which said latter company had applied for authority to purchase Vallecito stock, and which said authority was granted in October, 1963. Suburban has gained control of and does control Vallecito by means of Cal Fin's purchase of Vallecito stock or by means of Cal Fin's having caused the purchase of Vallecito stock enabled by Suburban's loan to Cal Fin.

"Cal Fin was unable to acquire Vallecito stock or cause Vallecito's stock to be acquired without Suburban's loan, and Suburban's loan enabled Cal Fin to acquire Vallecito stock or cause it to be acquired.

"No application, pursuant to Section 852 of the Public Utilities Code, to acquire Vallecito stock or to cause Vallecito stock to be acquired was made by Suburban or its alter ego Cal Fin or granted by the Commission. The purchase of Vallecito stock by Cal Fin in the manner described herein is tantamount to the purchase of said stock by Suburban and is in violation of Section 852 of the Public Utilities Code and is therefore void."

2. In Decision No. 71795, of which we take official notice, we found, among other things, that:

"Hickey acquired 18,003 shares of Vallecito stock from Toll & Co., nominee of Security First National Bank which equitably held said shares for Calfin Co., alter ego of Suburban Water Systems, a public utility water corporation, which had borrowed approximately \$279,000 from Security First National Bank to lend to Calfin to purchase said shares, and transfer them to Toll & Co. as holder and as security for Suburban's loan.

"Calfin, Suburban's alter ego, arranged with Security First National Bank for the latter to totally finance Hickey's stock purchase from Toll & Co. by a loan to Western Pacific Sanitation Company and a loan by Schumacher and Hale to Hickey in the amount of \$289,848.30 (18,003 shares @ \$16.10 per share).

"Hickey is an agent for the management and operation of Vallecito by Suburban.

"Hickey did not acquire said shares in good faith.

"The 18,003 shares acquired by Hickey were unlawfully held by Calfin, and the issuance and transfer by Vallecito of its Stock Certificate No. 1024 to Hickey was null and void and of no effect."

3. Applications Nos. 48753 and 48754 were authorized to be filed with the Commission by the directors of Vallecito who claim to have been elected at a meeting of the shareholders held on April 5, 1966. The election of these directors at the April 5, 1966 meeting was declared invalid by a judgment dated October 11, 1966 of the Superior Court of the State of California (Los Angeles County) in Case No. 883196, San Gabriel Valley Water Company v. Vallecito Water Company. Any action taken by these directors relative to Application Nos. 48753 and 48754 was a nullity.

4. On October 21, 1966 a special meeting of the shareholders of Vallecito was held to elect directors. Vallecito has 38,332 shares issued and outstanding; a majority of these shares (19,167)

is necessary to constitute a quorum for the transaction of business (Corp. Code Section 2211; Vallecito bylaws.) At the October 21, 1966 meeting the inspectors of election reported that 35,630 shares were represented in person or by proxy. Included in the 35,630 shares were 18,003 shares registered in the name of William J. Hickey and 13,691 shares registered in the name of San Gabriel Valley Water Company. San Gabriel objected to the counting of Hickey's shares in making up a quorum and in voting for directors. The inspectors of election overruled this objection and counted Hickey's shares. If Hickey's shares had not been counted only 17,627 shares, or 45.98 percent of the outstanding shares, would have been represented, which would not have been sufficient to constitute a quorum for the transaction of business.^{2/} At the October 21st meeting Harold M. Mathisen, Walker Hannon, and Howard M. Downs were purportedly elected as directors.

5. The transfer of stock to Calfin and Security First National Bank having been void, those entities had nothing to transfer to William J. Hickey, and, of course, Hickey has no right, title, or interest in the stock that he can exercise or convey. Therefore, neither William J. Hickey nor his proxy had any right to vote the void stock obtained from Calfin and Security First National Bank. It follows that the shares registered in Hickey's name should not have been counted to determine the presence of a

^{2/} At future meetings the prohibition against counting shares standing in Hickey's name might result in fewer than half of the outstanding shares being present for purposes of a quorum. This does not necessarily mean that valid elections cannot be held. (Cf. Burnett v. Banks (1955) 130 CA 2d 631, 637, 279 P 2d 579; Corp. Code Section 2238.)

quorum and, consequently, a quorum was not present, the directors elected on October 21, 1966 were not legally elected, and any action these directors took subsequent to October 21, 1966 relative to Applications Nos. 48753 and 48754 was a nullity. The directors of Vallecito are those who lawfully held office prior to the purported election of directors held April 5, 1966.

Vallecito argues that it had no choice but to count the shares standing in Hickey's name, and permit Hickey to vote them. Vallecito claims that at the time of the special meeting of shareholders on October 21, 1966 it was restrained from "interfering with the exercise of the ownership rights of William J. Hickey, including the right to vote said stock" with respect to the 18,003 shares registered in his name, by a decree of permanent injunction dated March 17, 1966, granted in Hickey v. W. H. Roby, et al., Superior Court Case No. 564,994 (City and County of San Francisco).^{3/}

Vallecito overlooks certain other facts pertinent to the validity of this stock transfer:

1. May 26, 1964 this Commission found the transfer of stock by Vallecito to Calfin and Toll & Co. to be void (Decision No. 67261).

2. November 10, 1964 this Commission ordered Suburban, Calfin, and Vallecito not to transfer any stock found to be void by Decision No. 67261 (Decision No. 68217).

^{3/} On March 20, 1967 in Superior Court Case No. 564994 the Commission moved to vacate and set aside the decree of permanent injunction dated March 17, 1966 on the following grounds: That the decree was secretly, collusively, and fraudulently obtained, and that it was an unlawful interference with the Commission in the performance of its official duties. Said motion was granted May 18, 1967.

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3. December 30, 1966 this Commission found Hickey to be the agent of Suburban (Decision No. 71795).

4. Camille Garnier is president of Suburban and president of Vallecito; W. H. Roby is secretary-treasurer of Vallecito.

5. It was the vote of Hickey's shares that elected the directors who appointed Mr. Garnier president of Vallecito and Mr. Roby secretary-treasurer of Vallecito.

Therefore, when Hickey sued Roby over a controversy involving stock of Vallecito it was in reality a suit by Suburban against Suburban. In other words, it was a collusive suit filed to obtain the injunction referred to above for the purpose of evading this Commission's decisions, so that Suburban could control Vallecito. Further, our order voiding the stock transfers to Calfin and Toll & Co. was not appealed, and is final. "In all collateral actions or proceedings, the orders and decisions of the Commission which have become final shall be conclusive" (Public Utilities Code Section 1709). "No court of the State, except the Supreme Court . . . shall have jurisdiction to review, reverse, correct, or annul any order or decision of the Commission or to suspend or delay the execution or operation thereof, or to enjoin, restrain, or interfere with the Commission in the performance of its official duties" (Public Utilities Code Section 1759.) We cannot be clearer or more succinct than that. Vallecito's argument is without merit.

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The Commission cannot wait for the parties to leisurely settle their disputes over the management of Vallecito. Vallecito's debt (discussed below) must be refinanced as quickly as possible, and on reasonable terms. To this end we must know the legitimate desires of the corporation as stated by its lawfully elected representatives. On this record we cannot make such a determination; and we will not tolerate further procrastination. If our orders concerning Vallecito, especially our order requiring Vallecito to reverse its stock transfer records and cancel all transfers of stock to Calfin Co., Toll & Co. and William J. Hickey (ordering paragraphs Nos. 4 and 6 in Decision No. 71795), are not carried out forthwith, the Chief Counsel of the Commission is authorized to commence action in the Superior Court of California pursuant to Public Utilities Code Sections 2102 and 2103, or any other pertinent statute, to enforce our orders.

By reason of the foregoing these applications are not properly before the Commission and will be denied on that ground. However, lest there be any misconception that the Commission has ignored the present or future needs of Vallecito or its customers, the merits of the applications will also be discussed.

Financing Requirements

Vallecito would apply the proceeds from the sale of its bonds to refunding past obligations, paying debts, and financing new construction.

Exhibit No. 28 sets forth these purposes as follows:

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APPLICATION OF PROCEEDS FROM THE SALE OF \$750,000 SERIES A BONDS

1.	Pay off \$125,000 Note at 7-1/2% - Security First National Bank	\$125,000
2.	Pay Interest To date of December 31, 1966	1,197
3.	Pay off \$100,000 Note at 7-1/2% - Security First National Bank	100,000
4.	Pay Interest to date of December 31, 1966	958
5.	Pay off \$275,000 Note at 6-1/2% - Salesmen Realty	275,000
6.	Pay Interest to date of December 31, 1966	23,088
7.	Pay 1965 Refund Contracts	37,096
8.	Pay 1966 Refund Contracts - Payable 1967	47,649
9.	Pay off Rockwell Mfg. Co. "Meters"	11,354
10.	Pay off Note at 5-3/8% with Sunset International Petroleum Corp.	40,000
11.	Modification of the Los Robles Booster Station	45,000
12.	Purchase Meters 1967	18,000
13.	Services	5,000
14.	Fire Hydrants	5,500
15.	Automatic Controls - Pumping Equipment	20,720
		<hr/>
		\$747,562

The four notes that are to be refunded (Items 1, 3, 5, and 10 of Exhibit No. 28) represent the lion's share of the bond proceeds. Normally, Vallecito's bond proposal would be the conventional means of refunding these obligations. But these are not normal obligations and Vallecito's financial maneuverings are not those usually associated with well-managed public utility water companies. Only two of the four notes, the \$125,000 note to the

Security First National Bank and the note to the Sunset Petroleum Corp., were authorized by this Commission. Both are for a reasonable term and carry a reasonable interest rate. On the other hand, the Salesmen Realty, Inc., note is shrouded in mystery. It is an unsecured note in the amount of \$275,000 dated March 26, 1965, payable in 90 days. This kind of note is unusual in water company practice, especially with companies as small as Vallecito. It has been in default, as to principal and interest for a year and a half, and no serious effort toward collection has been made. This is also unusual. None of those testifying on behalf of Vallecito, including two directors closely associated with management, admitted to knowing any more than that the note is due and unpaid - a further mystery in regard to such a large liability. All questions pertaining to the circumstances surrounding the execution of the note, the composition of Salesmen Realty, and the relationship, if any, between Vallecito, its president, Mr. Garnier, and Salesmen Realty, were answered with an averment of lack of knowledge. Mr. Garnier, the person who presumably does know something about this note, was out of the State. The inference we draw from this record concerning this note is that Mr. Garnier either personally guaranteed the note or Salesmen Realty is an alter ego of Mr. Garnier. In either case, we would be lax in our duty to the ratepayers to authorize the refunding of this obligation without determining the interest of all parties in the note. The evidence shows that none of the dealings between Salesmen Realty and Vallecito is that which is usually associated with an arms-length transaction. Of the two notes payable to the Security First National Bank one is personally guaranteed by Mr. Garnier

(the \$100,000 note) and the other is not. Both notes represent conventional financing and normally would be the proper subjects for refunding in the manner sought by Vallecito. But the \$100,000 note was issued for a period of less than a year, thereby avoiding the requirement of Commission approval, by a management that must have realized that this note, plus the \$125,000 note and the Salesmen Realty note, could not be refinanced without authority from this Commission; and by a management that knew that any financing requiring Commission approval would come under close scrutiny and take time. In other words, \$375,000 worth of notes were issued by Vallecito without Commission authority but with the knowledge that they could not be repaid without refinancing which would require Commission authority, thereby presenting the Commission with a fait accompli rather than an opportunity to determine whether the funds are needed and the terms of the notes are reasonable.^{4/} Further, Vallecito submits an application for financing authority with only one suggested form of financing, a bond issue, and requests expedited treatment because its creditors are pressing.^{5/} Vallecito expects too much.

4/ It is recognized that many well-managed utilities obtain short-term financing for proper purposes in anticipation of receiving authorization from this Commission for permanent financing. When such short-term financing is obtained through conventional methods generally accepted by the financial and utility communities, we do not consider such procedure improper.

5/ Application No. 48754 seeks authority to issue \$225,000 in notes to the Security First National Bank. This is not new financing but merely the substitution of new notes for old.

There is little dispute that the new construction proposed for 1967 (Exhibit No. 28 (set forth above), Items 11, 12, 13, 14 and 15) is needed. Vallecito estimates these costs as \$86,220. The only controversy concerns Item 15, automatic controls. Vallecito wishes to pay the balance of the entire cost of automatic controls (\$20,720) in 1967. But, the evidence shows that Vallecito has, or had, a contract permitting this item to be paid at the rate of \$690 per month, or \$8,280 per year; a more reasonable arrangement. In our opinion the funds required in 1967 for new construction proposed by Vallecito is not more than \$73,780.

The remaining items of Exhibit No. 28 cover the payment of interest on three of the notes discussed above, main extension contract refunds for 1966 and 1967, and an account payable for meter purchases.

Three methods of alleviating Vallecito's financial problems were presented at the hearing.

Vallecito proposes to refund its notes, pay its debts, and build new plant by issuing to Pacific Mutual Life Insurance Company bonds in the amount of \$750,000. Some of the main provisions of the issue are: interest rate on bonds, 6-1/2 percent; date of trust indenture, March 1, 1967; maturity date of bonds, March 1, 1987; and redemption shall not be permitted prior to March 1, 1974, unless certain penalty provisions are complied with. Pacific Mutual, on June 17, 1966, gave a commitment to purchase the entire bond issue at an interest rate of 6-1/4 percent on the assumption that the sale would be completed by November 1, 1966. Because the sale was not completed on time, and in consideration of a payment of \$6,000 by Vallecito, Pacific Mutual extended its

commitment to April 1, 1967 and imposed a further condition that the interest rate would be increased to 6-1/2 percent.

San Gabriel has proposed that Vallecito raise the required cash by selling stock, which San Gabriel is willing to purchase. This would give Vallecito the money it requires to operate, at no debt servicing cost to Vallecito. Such a sale would give San Gabriel control of Vallecito with the probable consequence of a merger of Vallecito into San Gabriel. Vallecito opposes this merger and refuses to sell its stock.

A third alternative is to deny Vallecito's application at this time, and until it gets its management problems corrected (discussed above). An analysis of Vallecito's recent income statements shows that the company generates enough money internally plus its cash on hand, to pay for the additions to plant that are required.

The evidence shows that Vallecito has cash on hand, as of December 31, 1966, of approximately \$52,000. It had a cash flow, in 1966, of approximately \$68,000;^{6/} in 1965 its cash flow was approximately \$65,500. The evidence also shows that Vallecito will continue to add new customers in 1967. Internally generated cash should not be less than it has been in the two previous years. This cash flow, plus cash already on hand, is sufficient to provide for the \$73,780 worth of improvements contemplated by the company.

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This is before provision for federal income tax; it is difficult to determine on the evidence presented what Vallecito's 1966 federal income tax liability will be, but it should be minimal.

In determining which of the three proposals should be put into effect we must reject the San Gabriel plan. Although this plan is practical, feasible, and has been authorized by the Commission (Decision No. 70011 dated November 26, 1965 in Applications Nos. 47790 and 47809) we have no way, in this proceeding, to require Vallecito to sell shares of its common stock to San Gabriel.

Vallecito's plan is also rejected. Not because it would be better for it to issue shares to San Gabriel, but because intrinsically it is unsound. It seeks to impose upon a small company, with a low earnings record, a long-term debt with an annual interest obligation of \$48,750. Under the proposed bond financing, Vallecito's interest expense of \$48,750 would be \$13,920 per year greater than its recorded 1966 interest expense of \$34,830. The cost of obtaining this financing is estimated to be approximately \$22,000 of which \$6,000 is a fee paid to Pacific Mutual for its commitment. If this \$22,000 is considered to be an expense of the bond issue, the effective rate of this issue would be 6.85 percent. Interest coverage, the amount of net income before taxes and bond interest, in relation to bond interest, is less than 1-1/2 to 1.^{7/} Sound financing requires an interest coverage greater than that resulting herein. Therefore, if we were to approve this bond issue, in order

^{7/} This ratio is based on Vallecito's exhibit showing net profit before income tax of \$16,925 plus interest expense of \$34,830 in 1966. If net profit is adjusted by deleting nonrecurring income from sale of land (\$6,903), by deleting the effect of capitalization of salaries and administrative expense (\$19,500), and by including the amount of pumpage reimbursement applicable to that year (\$11,660), there would be a loss of \$21,138, and much lower bond coverage.

to keep Vallecito in sound financial condition we would have to authorize an increase in its rates. Also, the 6-1/2 percent interest requirement is too high. When this application was filed and the prime rate for bank interest was the highest in forty years, the interest on these bonds was 6-1/4 percent. Since the application was filed the prime rate has gone down, but the interest rate on these bonds has been raised 1/4 of one percent. Vallecito offered no evidence in support of the reasonableness of this increase.

Finally, if this bond financing were authorized, Vallecito's current debt^{8/}-equity ratio, already too high, would be increased, and as a consequence the company's present precarious financial condition would be weakened further. The following table sets this forth.

	<u>Actual</u> (December 31, 1966)	<u>Percent</u>	<u>Pro Forma</u>	<u>Percent</u>
Notes	\$542,500		\$750,000	
Advances for Construction	<u>1,045,060</u>		<u>960,314</u>	
Debt	\$1,587,560	73.83	\$1,710,314	75.25
Equity	<u>562,600</u>	26.17	<u>562,600</u>	24.75
	<u>\$2,150,160</u>		<u>\$2,272,914</u>	
Notes	\$542,500	49.09	\$750,000	57.14
Equity	<u>562,600</u>	50.91	<u>562,600</u>	42.86
	<u>\$1,105,100</u>		<u>\$1,312,600</u>	

^{8/} Debt includes advances for construction as well as long-term notes.

The capital ratios shown in the above tabulation indicate that Vallecito's capital structure is unbalanced due to its construction having been primarily financed through issues of long-term debt and by consumers' advances. Even if consumers' advances are eliminated from the computation, the capital ratios as of December 31, 1966, and on a pro forma basis, show that long-term debt represents 49 percent and 57 percent, respectively, of Vallecito's capital structure. The Commission does not look with favor upon any permanent debt ratio of the magnitude above shown, and is of the opinion that Vallecito's necessary financing should be obtained through the issuance of equity securities or at least a combination of debt and equity. For these reasons it would be economically unsound to authorize Vallecito to issue \$750,000 in bonds at this time.

By process of elimination Vallecito is left with no recourse but to provide for currently needed operating improvements out of internally generated funds. This is feasible, as discussed above. Vallecito will have to handle its creditors as best it can until sound long-term financing, satisfactory to this Commission, is provided. Vallecito, by proposing unsound financing plans, could place its ability to serve in jeopardy. This the Commission will not permit. The Commission staff will be instructed to take all necessary steps to prevent any deterioration in service. As long as service to the ratepayers remains unimpaired the Commission need not be hurried into an irrevocable decision that could prove both harmful and costly to the company and to the ratepayers.

The impact of denying Vallecito's financing proposal will create problems for the company. Even if Vallecito withholds

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payment of principal and interest on the notes to Salesmen Realty and Security First National Bank its estimated income in 1967 will not be sufficient to balance estimated outflow.

<u>Source of Funds</u>	
Commercial Sales	\$342,280
Other Revenue	<u>1,840</u>
	\$ 344,120

<u>Application of Funds</u>	
Operation Expense	\$171,000
Taxes	55,300
Sunset International Note	2,500
Assessable Pump Reimbursement	11,660
Fed. Inc. Tax Assess.	27,000
Main Extension Refunds	84,745
Modification of Los Robles Booster	45,000
Rockwell Mfg. Co. (past meter expense)	11,355
Meters	10,000
Services	5,000
Fire hydrants	5,500
Automatic controls	<u>8,280</u>
	\$437,340
	<u>\$ (93,220)</u>
Cash in bank	52,000
deficit	<u>\$ (41,220)</u>

The anticipated cash shortage will have a short term adverse impact on the company. Some payments will have to be deferred and some construction may have to be postponed. Also, it may reasonably be inferred that conventional short-term financing will not be available to the company (although that absence has not interfered with past financing). There is no evidence that this situation will have an adverse effect on service to the ratepayers.

Over the long run, our denial of this application should have no substantial effect on the operations of Vallecito. The company is basically sound, is in a growth area, and has a low,

but consistent, earnings record. There is no doubt that the company's debt must be refinanced in a relatively short time. But this refinancing must be on terms the Commission finds reasonable; not on the take it or else basis that Vallecito submits. It is possible, although not probable, that Salesmen Realty and the Security First National Bank will take legal action to collect their notes. In such a case there would be added expense to Vallecito. This unfortunate consequence is a direct result of Vallecito's failing to adequately anticipate its financial requirements and by its making improvements in plant prior to obtaining adequate financing.

The Commission makes the following findings of fact:

1. Vallecito Water Company seeks authority to issue and sell First Mortgage Series A 6-1/2 percent bonds due March 1, 1987 so that it may refund past obligations, pay debts, and finance new construction; or, in the alternative to issue promissory notes in the amount of \$225,000.

2. Notes in the amount of \$375,000 were issued by Vallecito without Commission approval - a \$100,000 note to Security First National Bank and a \$275,000 note to Salesmen Realty, Inc. These notes were issued by Vallecito with the knowledge that they could not be repaid without refinancing which would require Commission authority. The Commission had no opportunity to determine whether the funds were needed or the terms of the notes reasonable.

3. As to the Salesmen Realty, Inc. note for \$275,000, none of the directors of Vallecito who testified admitted knowing anything about the origin of the note. They did not know the circumstances surrounding the execution of the note, the composition of Salesmen Realty, or the relationship between Vallecito, its president, Mr. Garnier, and Salesmen Realty. The dealing between Vallecito and Salesmen Realty, Inc. was not an arms-length transaction.

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4. The new construction proposed by Vallecito in 1967 is reasonable; the costs of this construction are reasonable except for the cost of automatic controls which should be no more than \$8,280 in 1967.

5. Vallecito had cash on hand, as of December 31, 1966, of approximately \$52,000. It had a cash flow, in 1966 of approximately \$68,000; in 1965 its cash flow was approximately \$65,500. Vallecito will continue to add new customers in 1967. Internally generated cash should not be less than it has been in the two previous years. This cash flow, plus cash already on hand, is sufficient to provide for the \$73,780 cost of improvements contemplated by the company. ✓

6. Vallecito's plan to issue mortgage bonds is unsound. It seeks to impose upon a small company, with a low earnings record, a long-term debt with an annual interest obligation of \$48,750. Under the proposed bond financing, Vallecito's interest expense of \$48,750 would be \$13,920 per year greater than its recorded 1966 interest expense of \$34,830. The cost of obtaining this financing is approximately \$22,000 of which \$6,000 is a fee paid to Pacific Mutual for its commitment. Including this \$22,000 as an expense of the bond issue, the effective rate of this issue is 6.85 percent. Interest coverage is less than 1-1/2 to 1. Sound financing requires an interest coverage greater than that resulting herein. Therefore, if we were to approve this bond issue, in order to keep Vallecito in sound financial condition we would have to authorize an increase in its rates. The 6-1/2 percent interest requirement

is too high. When this application was filed and the prime rate for bank interest was the highest in forty years, the interest on these bonds was 6-1/4 percent. Since the application was filed the prime rate has gone down, but the interest rate on these bonds has been raised 1/4 of one percent. Vallecito offered no evidence in support of the reasonableness of this increase.

7. If this bond financing were authorized, Vallecito's current debt-equity ratio, already too high, would be increased, and as a consequence the company's present precarious financial condition would be weakened further. Vallecito's capital structure is unbalanced due to its construction having been primarily financed through issues of long-term debt and by consumers' advances.

8. Vallecito offered no evidence showing an inability to secure long-term financing at a more favorable interest rate than that demanded by Pacific Mutual.

9. The fixed charges which would result from the issuance of the proposed first mortgage bonds are unsound and not in the public interest.

10. Under present and foreseeable earnings of Vallecito, the coverage of the annual interest requirements of the proposed first mortgage bonds is inadequate.

11. The annual interest requirements of the proposed first mortgage bonds are so great as to require Vallecito to substantially reduce its expenses and thereby adversely affect service to ratepayers or secure an increase in its rates for water service in order to earn the required interest and to

provide an adequate coverage of the interest requirements.

12. Under the proposed Purchase Agreement between Vallecito and Pacific Mutual, Vallecito is required to represent (a) that its financial statements have been prepared in accordance with generally accepted principles of accounting; (b) that they are correct and truly represent the financial condition of Vallecito as of the dates thereof and the results of operations for the periods shown therein; (c) that there are no actions, suits or proceedings at law or before any governmental body, which would be likely to adversely affect Vallecito; and (d) that Vallecito is not in default in respect of any order of any governmental commission. Vallecito, at the time of the hearings herein, could not truthfully make the foregoing representations, and did not show that at the time of the closing of the proposed transaction it could make such representations.

13. The financial statements presented by Vallecito have not been prepared in accordance with generally accepted principles of accounting and do not truly represent the financial condition of Vallecito in that they reflect the arbitrary and excessive capitalization of officers' salaries and other administrative expenses resulting in an overstatement of income and of net utility plant, and do not reflect admitted liabilities of the company.

14. The denial of these applications will have no adverse effect on service to the ratepayers or on the long-term operations of Vallecito.

15. In Decision No. 67261, of which we take official notice, we found, among other things, that:

"Suburban obtained a loan from Security First National Bank-Whittier Branch, in May, 1963; at least \$279,600 of the proceeds of said loan were then loaned to Cal Fin, a wholly owned subsidiary of Suburban; Cal Fin's officers and directors are interlocking and for the purposes of this proceeding Cal Fin is the alter ego of Suburban. Cal Fin purchased or caused to be purchased Vallecito stock with said funds for the purpose of preventing the majority of Vallecito stock from being sold to San Gabriel Water Company's president, which said latter company had applied for authority to purchase Vallecito stock, and which said authority was granted in October, 1963. Suburban has gained control of and does control Vallecito by means of Cal Fin's purchase of Vallecito stock or by means of Cal Fin's having caused the purchase of Vallecito stock enabled by Suburban's loan to Cal Fin.

"Cal Fin was unable to acquire Vallecito stock or cause Vallecito's stock to be acquired without Suburban's loan, and Suburban's loan enabled Cal Fin to acquire Vallecito stock or cause it to be acquired.

"No application, pursuant to Section 852 of the Public Utilities Code, to acquire Vallecito stock or to cause Vallecito stock to be acquired was made by Suburban or its alter ego Cal Fin or granted by the Commission. The purchase of Vallecito stock by Cal Fin in the manner described herein is tantamount to the purchase of said stock by Suburban and is in violation of Section 852 of the Public Utilities Code and is therefore void."

16. In Decision No. 71795, of which we take official notice, we found, among other things, that:

"Hickey acquired 18,003 shares of Vallecito stock from Toll & Co., nominee of Security First National Bank which equitably held said shares

for Calfin Co., alter ego of Suburban Water Systems, a public utility water corporation, which had borrowed approximately \$279,000 from Security First National Bank to lend to Calfin to purchase said shares, and transfer them to Toll & Co. as holder and as security for Suburban's loan.

"Calfin, Suburban's alter ego, arranged with Security First National Bank for the latter to totally finance Hickey's stock purchase from Toll & Co. by a loan to Western Pacific Sanitation Company and a loan by Schumacher and Hale to Hickey in the amount of \$289,848.30 (18,003 shares @ \$16.10 per share).

"Hickey is an agent for the management and operation of Vallecito by Suburban.

"Hickey did not acquire said shares in good faith.

"The 18,003 shares acquired by Hickey were unlawfully held by Calfin, and the issuance and transfer by Vallecito of its Stock Certificate No. 1024 to Hickey was null and void and of no effect."

17. Application Nos. 48753 and 48754 were authorized to be filed with the Commission by the directors of Vallecito who claim to have been elected at a meeting of the shareholders held on April 5, 1966. The election of these directors at the April 5, 1966 meeting was declared invalid by a judgment dated October 11, 1966 of the Superior Court (Los Angeles County) in Case No. 883196, San Gabriel Valley Water Company v. Vallecito Water Company. Any action taken by these directors relative to Application Nos. 48753 and 48754 was a nullity.

18. On October 21, 1966 a special meeting of the shareholders of Vallecito was called to elect directors. Vallecito has 38,332 shares issued and outstanding; a majority of these shares (19,167) is necessary to constitute a quorum for the transaction of business.

At the October 21, 1966 meeting the inspectors of election reported that 35,630 shares were represented in person or by proxy. Included in the 35,630 shares were 18,003 shares registered in the name of William J. Hickey and 13,691 shares registered in the name of San Gabriel Valley Water Company. San Gabriel objected to the counting of Hickey's shares in making up a quorum and in voting for directors. The inspectors of election overruled this objection and counted Hickey's shares. If Hickey's shares had not been counted only 17,627 shares, or 45.98 percent of the outstanding shares, would have been present, which would not have been sufficient to constitute a quorum for the transaction of business. At the October 21st meeting Harold M. Mathisen, Walker Hannon, and Howard M. Downs were purportedly elected as directors.

19. The transfer of stock to Calfin and Security First National Bank having been void, those entities had nothing to transfer to William J. Hickey, and, of course, Hickey has no right, title, or interest in the stock that he can exercise or convey. Therefore, neither William J. Hickey nor his proxy had any right to vote the void stock obtained from Calfin and Security First National Bank. It follows that the shares registered in Hickey's name should not have been counted to determine the presence of a quorum and, consequently, a quorum was not present, the directors elected on October 21, 1966 were not legally elected, and any action these directors took subsequent to October 21, 1966 relative to Application Nos. 48753 and 48754 was a nullity. The

lawful directors of Vallecito are those who lawfully held office prior to the purported election of directors held April 5, 1966.

20. On October 21, 1966, the day of the special meeting of shareholders, an order of the Superior Court dated March 17, 1966 permanently enjoined Vallecito from "interfering with the exercise of the ownership rights of William J. Hickey, including the right to vote said stock" with respect to the 18,003 shares registered in his name. (Hickey v. Roby, San Francisco Superior Court Case No. 564994, injunction vacated and set aside May 18, 1967.) At the time that this injunction was issued the Court had not been informed of our holding that the stock transfers to Hickey's predecessor in interest were void and that, as a consequence of our holding, Hickey had no interest in the stock. This injunction was void, and ineffective to clothe Hickey with any rights in Vallecito stock.

21. November 10, 1964 this Commission ordered Suburban, Calfin, and Vallecito not to transfer any stock found to be void by Decision No. 67261 (Decision No. 68217).

22. Camille Garnier is president of Suburban and president of Vallecito; W. H. Roby is secretary-treasurer of Vallecito. It was the vote of Hickey's shares that elected the directors who appointed Mr. Garnier president of Vallecito and Mr. Roby secretary-treasurer of Vallecito.

23. When Hickey sued Roby over a controversy involving stock of Vallecito it was in reality a suit by Suburban against Suburban. It was a collusive suit filed to obtain the injunction referred to in Finding No. 20 for the purpose of evading this Commission's decisions, so that Suburban could control Vallecito.

24. Vallecito has failed to reverse on its books the record of stock transfers to Toll & Co. for the benefit of Calfin Co.

A. 48573, A. 48754 ds */lm *

which the Commission has found in Decision No. 67621 to have been effected in violation of Section 852 of the Public Utilities Code.

25. Vallecito has failed to show that the filing of the applications herein and the execution by the corporation of a bond purchase agreement at an interest rate of 6-1/2 percent have been duly authorized.

26. No facts have been adduced to persuade us to rescind that portion of Decision No. 68077 dated October 20, 1964 directing Vallecito to cause to be published a notice regarding its financial status.

27. Vallecito's financing applications should be denied because the persons who authorized the filing of the applications had no authority to so authorize, and the proposed methods of financing are inadequate.

Based on the foregoing findings of fact the Commission concludes that Applications Nos. 48753 and 48754 should be denied.

A. 48753, A. 48754 - ds *

O R D E R

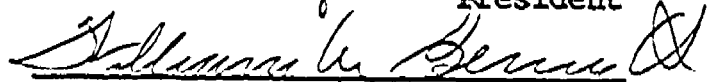
IT IS ORDERED that Applications Nos. 48753 and 48754 are denied.

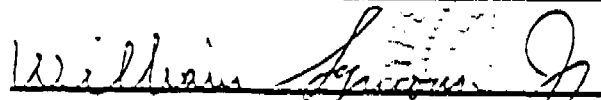
The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 23rd day of May, 1967.



President







Commissioners

Commissioner Gatov present but not participating in discussion or voting.