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Local Government Law Bulletin

Municipal Annexation of Territory Served by FmHA-Funded Water and Waste Associations

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The Consolidated Farm and Rural Development Act[1] authorizes the Farmers Home Administration (FmHA) to make loans to encourage the development of water and waste facilities in rural areas. The authorizing clause [Section 1926(a)(1)] specifies that such loans may be made to "associations, including corporations operated not for profit, Indian tribes on Federal and State reservations . . . and public [or] quasi-public agencies."

Through the following protective provision, the act then limits the danger that these FmHA-funded water and waste associations will be unable to repay their loans:

> [S]ervice provided or made available through any such association shall not be curtailed or limited by inclusion of the area served by such an association within the boundaries of any municipal corporation or other public body, or by the granting of any private franchise for similar service within such area during the term of such loan; nor shall the happening of any such event be the basis of requiring such association to secure any franchise, license, or permit as a condition to continuing to serve the area served by the association at the time of the occurrence of such event.[2]

In order to clarify how the protective provision affects municipalities that annex land served by FmHA-funded rural water and waste systems, this *Local Government Law Bulletin* will address the following questions:

1. What effect does the protective provision have on a municipality's annexation power?
2. How does the protective provision affect a municipality's rights and duties in relation to a newly annexed area that is served by a FmHA-funded rural water or waste system?
   a. What does *associations* in the protective provision mean? Are all FmHA-funded rural water and waste facilities protected from curtailment or limitation of service?
   b. What constitutes curtailment or limitation of service?
   c. For what period of time does the protection apply?

Annexation

Although the text of Section 1926(b) refers to curtailment or limitation of service through "inclusion of the area served . . . within the boundaries of any municipal corporation or other public body," it does not directly ban annexation. If the municipality annexing a rural water or waste association's service area does not interfere or compete with the existing service, Section 1926(b) does not come into play at all. If the municipality's annexation does—or has the potential to—affect the rural association's service, Section 1926(b) applies but does not affect the validity of the annexation. The remedy for an annexation which encroaches on a rural water or waste association's service is an injunction prohibiting continuation and/or expansion of the competitive service for the duration of the FmHA loan.[3]

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1. 7 U.S.C.A. §§ 1921-2006 (West 1988).
2. 7 U.S.C.A. § 1926(b) (West 1988).
3. The language of Section 1926(b) would seem to require that a municipal water service that competes with

In a limited set of circumstances, however, the protective provision of the act can make annexation unattractive enough to impose a ban in fact, if not in law. North Carolina law requires that an annexing municipality ensure that annexed territories have water and waste services,[4] commensurate with those available in the rest of the municipality.[5] If an annexed area has existing service sufficient to satisfy a municipality's state-mandated obligations, no problem arises.[6]

Two situations can occur, however, where the municipality may be obliged to provide the service itself. The first, of course, is where there is no existing service at the time of annexation; the second is where the service provided is substandard in comparison to that provided in the rest of the municipality. In the latter case, the municipality may have to supplement or supplant existing services.

The problem arises when the substandard service is provided by a FmHA-funded rural association: here, the state supplementation requirements conflict with the federal mandates of the protective clause. Unless the rural water or waste association consents, a municipality may not install parallel lines for water and sewer service.[7] The municipality is then faced with the following options: negotiate for the purchase of the facilities owned by the rural association at a rate adequate to ensure repayment of the FmHA loan, or pay for any necessary upgrade of the association's lines itself.

a FmHA-funded rural water association service be enjoined from continuing all service in the disputed area, but at least one court has found it sufficient to prohibit only further expansion of the service. *See* Rural Water Dist. #3 v. Owasso Util. Auth., 530 F. Supp. 818 (N.D. Okla. 1979).

4. N.C. GEN. STAT. Section 160A-47(3)(a)-(c) provides that a municipality must submit plans to provide police and fire protection, garbage collection, street maintenance, major trunk water mains, and sewer outfall lines to the area it intends to annex. [Hereinafter the General Statutes will be cited as G.S.]

5. Stillings v. City of Winston-Salem, 63 N.C. App. 618, 306 S.E.2d 489 (1983), *rev'd on other grounds*, 311 N.C. 689, 319 S.E.2d 233 (1984).

6. G.S. 160A-47(3)(a)-(c). *See also* G.S. 160A-49.1 *and* 162A-93(c) for examples of existing services in the annexed area that can satisfy the municipality's service requirements.

7. *See* Glenpool Util. Serv. Auth. v. Creek County Rural Water Dist. No. 2, No. 91-5047 (10th Cir. Feb. 25, 1992) (1992 U.S. App. LEXIS 3369) ("Glenpool cannot justify its expansion into the District's territory by arguing that the District did not have adequate water supplies to serve the area").

After Annexation: Are All FmHA-Funded Water and Sewage Services Protected by the Federal Development Act?

In North Carolina, thirty-nine of the one hundred rural water and waste services indebted to FmHA are private, nonprofit entities, run by members, with rate schedules approved by FmHA.[8] The remaining sixty-one services are public entities: counties, towns, sanitary districts, and other special-function districts.[9] The latter group has the status of municipal corporations.

The question is: does the protective provision apply to these public bodies or only to the private, nonprofit associations?

Case Law

None of the case law dealing with the protective provision of the development act has specifically addressed this issue: *association* has never been defined. But even in the absence of a definition, cases dealing with other aspects of the provision have extended its protection to rural water and waste facilities of all kinds—including public bodies.[10] The one North Carolina case on point follows this trend.[11] This bright-line application of the protective provision makes some sense when viewed in light of the federal government's desire to ensure that all borrowers of FmHA money continue in service long enough to repay their loans. But the wording of the statute does not reveal on its face that this is the correct application, and its legislative history, as well as relevant Code of Federal Regulations provisions indicate that only private, nonprofit rural water and waste associations should qualify for protection.

8. Letter from B. A. Parker, Chief of Community and Business Programs, State of North Carolina Farmers Home Administration, to Ingrid Johansen, Institute of Government (June 15, 1992) (on file with author).

9. *Id.*

10. For cases extending the protection of Section 1926(b) to private, non-profit entities, see Glenpool Util. Serv. Auth. v. Creek County Rural Water Dist. No. 2, 861 F.2d 1211 (10th Cir. 1988); City of Madison, Miss. v. Bear Creek Water Ass'n, Inc., 816 F.2d 1057 (5th Cir. 1987); Jennings Water, Inc. v. City of North Vernon, Ind., 682 F. Supp. 421 (S.D. Ind. 1988); Moore Bayou Water Ass'n, Inc. v. Town of Jonestown, 628 F. Supp. 1367 (N.D. Miss. 1986). For cases extending the protection of Section 1926(b) to public entities, see Water Works Dist. No. II of Tangipahoa Parish v. City of Hammond, No. 86-0187 (E.D. La. Oct. 3, 1989) (1989 U.S. Dist. LEXIS 11752); Pinehurst Enter., Inc. v. Town of Southern Pines, 690 F. Supp. 444 (M.D.N.C. 1988); Rural Water Dist. #3 v. Owasso Util. Auth., 530 F. Supp. 818 (N.D. Okla. 1979).

11. *Pinehurst Enter.*, 690 F. Supp. 444.

Wording of the Development Act

The *authorizing* clause of the Consolidated Farm and Rural Development Act lists the entities that may receive FmHA loans for water and sewer facilities: "associations, including corporations not operated for profit, Indian tribes . . . and public [or] quasi-public agencies." The *protective* provision of the act grants protection only to "service provided or made available through any such association." If the discrepancy between the list of terms in the authorizing clause and the use of *association* alone in the protective provision occurred only in the statute's text, the argument that the term *association* is merely a referent for nonprofits, Indian tribes, and public agencies would probably be persuasive, given the goal of the protective provision. If that is the case, all FmHA-indebted rural water providers in North Carolina are protected from having their service curtailed or limited.

Legislative History

However, *associations* are differentiated from *public bodies* in the legislative history of the development act and in the Code of Federal Regulations. The legislative history of the protective provision states that a "new provision has been added to assist in protecting the territory served by such an association facility against competitive facilities, which might otherwise be developed with the expansion of the boundaries of municipal and other public bodies . . . ."[12] Here public bodies are perceived as entities which would threaten the continued viability of FmHA-funded rural associations—not as entities in need of federal protection.

Code of Federal Regulations

Additional support for the argument that only private, nonprofit entities are covered by the protective provision comes from the Code of Federal Regulations. The following is the manner in which it lists the types of applicants eligible for water and waste facility loans:

(i) *Public bodies* such as municipalities, counties, districts, authorities, or other political subdivisions of a State.

(ii) *Organizations operated on a not-for-profit basis* such as associations, cooperatives, and private corporations . . . .

(iii) *Indian tribes* on Federal and State reservations and other Federally recognized Indian tribes.[13]

This separation of the groups reveals that the term *association* as used in the authorizing clause is not descriptive of all the terms following thereafter, but describes a separate entity consisting only of nonprofit, private bodies. Therefore, if the protective provision was intended to extend not only to nonprofit, private bodies but also to Indian tribes and public or quasi-public bodies, each entity would have been listed again. Further, the Code differentiates *public bodies* from *other-than-public bodies* in terms of loan security.[14] If different methods of insuring loans are used for public and nonpublic bodies, different methods of protecting such loans seems entirely plausible.

What Constitutes Curtailment or Limitation of Service?

Any municipal actions that impair the ability of a rural association to repay its loan to FmHA are prohibited by the protective provision [Section 1926(b)] of the Consolidated Farm and Rural Development Act. These actions include condemning a rural association's facilities;[15] installing competing lines within the association's service area;[16] and requiring an association to obtain a franchise[17] or granting a competing franchise within the association's service area.[18]

Condemning Facilities

Case law arising under the protective provision has flatly prohibited condemnation of facilities run by FmHA-funded rural water and waste associations. These cases focus on whether any customer of the rural water association has been cut off from the

12. S. Rep. No. 566, 87th Cong., 1st Sess., *reprinted in* 1961 U.S.C.C.A.N. 2243, 2309.

13. 7 C.F.R. § 1942.17(b) (1992).

14. 7 C.F.R. § 1942.17(g) (1992).

15. *See* City of Madison, Miss. v. Bear Creek Water Ass'n, Inc., 816 F.2d 1057 (5th Cir. 1987); Moore Bayou Water Ass'n, Inc. v. Town of Jonestown, 628 F. Supp. 1367 (N.D. Miss. 1986).

16. *See* Glenpool Util. Serv. Auth. v. Creek County Rural Water Dist. No. 2, 861 F.2d 1211 (10th Cir. 1988); Water Works Dist. No. II of Tangipahoa Parish v. City of Hammond, No. 86-0187 (E.D. La. Oct. 3, 1989) (1989 U.S. Dist. LEXIS 11752); Rural Water Dist. #3 v. Owasso Util. Auth., 530 F. Supp. 818 (N.D. Okla. 1979).

17. 7 U.S.C.A. § 1926(b) (West 1988).

18. *But see* Comanche Rural Water Dist. No. 1 v. City of Lawton, 501 P.2d 490 (Okla. 1972).

service area—the question of what proportion of the association's revenue the lost customers contributed is irrelevant.[19] Courts have reasoned that anything which reduces the economy of scale of the association impairs its ability to repay its loan.[20]

Installing Parallel Lines

Installation of service lines parallel to those of a rural water or waste association is also prohibited, whether the association's service area is within[21] or without[22] municipal limits. That the protective provision applies to service areas outside municipal limits is not necessarily an intuitive result, given the section's language prohibiting curtailment or limitation "by inclusion of the area served by such an association within the boundaries of any municipal corporation or other public body." The result has been justified, though, as effectuating the statute's goal of ensuring loan repayment.[23]

The question may arise: How is the association's service area defined? When the FmHA-indebted facility is run by a public body, the service area is usually defined by the limits of the city, town, or district.[24] When the facility is run by a private, nonprofit entity, the boundaries of the service area tend to be less well defined and less easily identifiable. FmHA will reject a loan application if the proposed service area will not provide a sufficient customer base to be economically feasible,[25] but once a rural association has received a FmHA loan, it may change the size of its service area without notifying FmHA.[26] Thus the boundaries of the service area in the original loan application may not be current. The only limit on the authority of an association to change its service area is that it cannot claim land, without a municipality's consent, that is already a part of the municipality.[27]

Requiring or Granting Private Franchises

The protective provision states that a rural water or waste association cannot be required to obtain a "franchise, license, or permit as a condition to continuing to serve the area served by the association." The power to grant a franchise carries with it the power to make it illegal for an organization to operate without one.[28] In North Carolina, a municipality can grant a franchise to a service only when the service is within municipal limits:[29] therefore, competitive municipal activity that occurs outside municipal limits but inside a rural association's service area does not constitute a grant of franchise and can be addressed only under that section of the protective provision that bans curtailment of an association's service.[30]

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19. *City of Madison*, F.2d 1057.

20. *Id.*

21. *See* Glenpool Util. Serv. Auth. v. Creek County Rural Water Dist. No. 2, 861 F.2d 1211 (10th Cir. 1988) (municipality may not use its annexation of territory within rural water district as springboard for supplying water service to its own residents within district).

22. *See* Rural Water Dist. #3 v. Owasso Util. Auth., 530 F. Supp. 818 (N.D. Okla. 1979) (municipality may not expand its provision of utility service to area outside corporate limits and within rural water district's service area).

23. *See City of Madison*, 816 F.2d 1057.

> [The] language indicates a congressional mandate that local governments not encroach upon the services provided by such associations, be that encroachment in the form of competing franchises, new or additional permit requirements, or *similar means* . . . to allow a city to do via condemnation what it is forbidden by other means, would render nugatory the clear purpose of § 1926(b). (Emphasis added.)

24. Conversation with Thurman Murphy, Jr., Assistant District Director, Henderson District Farmers Home Administration (June 30, 1992).

25. *Id.*

26. *Id.*

27. G.S. 160A-316; 162A-87.1. This is not, however, to say that municipal annexation of part of a rural association's service area removes that land from the service area. In this situation, a first-in-time, first-in-right principle applies: regardless of whether the area in dispute was receiving water service at all, the right to subsequently provide water service belongs to the entity within whose boundaries the land first fell. *See, e.g.*, Glenpool Util. Serv. Auth. v. Creek County Rural Water Dist. No. 2, No. 91-5047 (10th Cir. Feb. 25, 1992) (1992 U.S. App. LEXIS 3369); Watson Rural Water Co, Inc. v. Indiana Cities Water Corp., 540 N.E.2d 131 (Ind. App. 1989).

28. G.S. 160A-319.

29. G.S. 160A-319 provides that a "city shall have authority to grant upon reasonable terms franchises for the operation within the city of any of the enterprises listed in G.S. § 160A-311 (i.e. electric power generation, water supply and distribution, sewage collection and disposal, gas production, and public transportation)."

30. *See* Jennings Water, Inc. v. City of North Vernon, Ind., 682 F. Supp. 421 (S.D. Ind. 1988) (municipal encroachment includes contracting to sell water to a distributor who had previously bought water from rural water association). *But see* Comanche Rural Water Dist. No. 1 v. City of Lawton, 501 P.2d 490 (Okla. 1972) [municipal sale of water to private distributor within rural water association's service area did not amount to grant of franchise, and was therefore not prohibited by Section 1926(b).]

The prohibition on franchises applies only to associations operating within municipal limits.

What Guidelines Have Courts Used When Assessing the Effect of a Municipal Action?

When assessing whether municipal action impairs the ability of rural associations to repay their FmHA loans, the courts have taken two approaches. Though these differ only subtly, they may have implications for the showing required of rural associations alleging curtailment. The first approach does not require a showing of actual default on loan payments,[31] but may require some showing of impaired ability to repay. The second approach does not require a showing of any effect on the association's ability to repay the loan.[32]

The second approach is the more common and frequently cited:[33] it employs an irrebuttable presumption of impairment whenever a rural water association loses—or has the potential to lose—a customer. The emphasis here is on loss of business per se, not on how the loss affects loan repayment capability. Where it operates, the presumption of impairment holds true if the association has only $1.00 outstanding on its FmHA loan[34] or if the monetary value of the lost custom constitutes only .01 percent of the association's revenues.[35] Courts using this approach seem motivated by a fear of piecemeal erosion of the association's customer base[36] and of lengthy, repetitious litigation.[37]

To date, the Fourth Circuit has not addressed this issue. It might be worth while to advance the argument that the first standard—actual impairment—is more appropriate than the second standard—potential impairment. The purpose of the protective provision is to ensure that rural associations indebted to FmHA are able to repay their loans. This goal does not necessitate granting utility monopolies to these associations.

For What Period Is Competition Prohibited?

The protective provision of the Farm and Rural Development Act protects a rural water and waste association only for the term of the FmHA loan. FmHA regulatory requirements provide that no loan to a rural association will have a term that "exceed[s] the useful life of the facility or [exceeds] 40 years from the date of the note(s) or bond(s), whichever is less."[38] Of course no regulation prevents an association from acquiring subsequent loans at a later date, but whenever the debt obligation of the association ends, so does the protection of the development act.[39]

In addition, the protective provision does not extend to rural water or waste associations whose loans FmHA has sold without insurance to the private sector.[40] A rural association may also lose the protection of Section 1926(b) when its loan is assumed by a transferee who would not be eligible for a loan under the FmHA program.[41] These loans are then called nonprogram loans.[42]

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31. Rural Water Dist. #3 v. Owasso Util. Auth., 530 F. Supp. 818, 820 (N.D. Okla. 1979).

32. *See* City of Madison, Miss. v. Bear Creek Water Ass'n, Inc., 816 F.2d 1057 (5th Cir. 1987); *see also* Jennings Water, Inc. v. City of North Vernon, Ind., 682 F. Supp. 421 (S.D. Ind. 1988).

33. *See City of Madison*, 816 F.2d 1057; *see also Jennings Water*, 682 F. Supp. 421.

34. *City of Madison*, 816 F.2d at 1059.

35. Moore Bayou Water Ass'n, Inc. v. Town of Jonestown, 628 F. Supp. 1367, 1369–70 (N.D. Miss. 1986); *see also Jennings Water*, 682 F. Supp. at 425; Water Works Dist. No. II of Tangipahoa Parish v. City of Hammond, No. 86-0187 (E.D. La. Oct. 3, 1989) (1989 U.S. Dist. LEXIS 11752).

36. Moore Bayou Water Ass'n, Inc. v. Town of Jonestown, 628 F. Supp. 1367, 1370 (N.D. Miss. 1986).

37. *City of Madison*, 816 F.2d at 1059.

38. 7 C.F.R. § 1942.17(f)(7).

39. *See* Glenpool Util. Serv. Auth. v. Creek County Rural Water Dist. No. 2, 861 F.2d 1211, 1214, 1216 (10th Cir. 1988); *City of Madison*, 916 F.2d at 1061 .

40. 7 C.F.R. § 1951.201.

41. 7 C.F.R. § 1942.17(b), (c); 7 C.F.R. § 1951.230(d).

42. 7 C.F.R. § 1951.216.

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