

California Debt and Investment Advisory Commission

ABC's of School Debt Financing Debt Financing Mechanisms – Part 2

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Hilton Ontario Airport Hotel

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Lease Financing Structures

What is Lease Financing?

- ❖ **Financing mechanism permitting a School District (lessee) to finance property to be repaid with lease payments**
- ❖ **Lease obligation not viewed as debt under the California Constitution**
- ❖ **Generally available to finance any School District project or property / equipment acquisition over time *without* voter approval**

What is Lease Financing?

Lease financings are usually structured using the following:

- ❖ **Direct Lease**
- ❖ **Certificates of Participation (“COPs”)**
- ❖ **Lease Revenue Bonds**

Direct Lease



Ideal for acquisition of equipment, buses and relocatable classrooms

Vendor, Leasing Company or Bank serves as lessor

Term equals useful life of leased asset (generally 3-10 years)

Direct Lease Structure



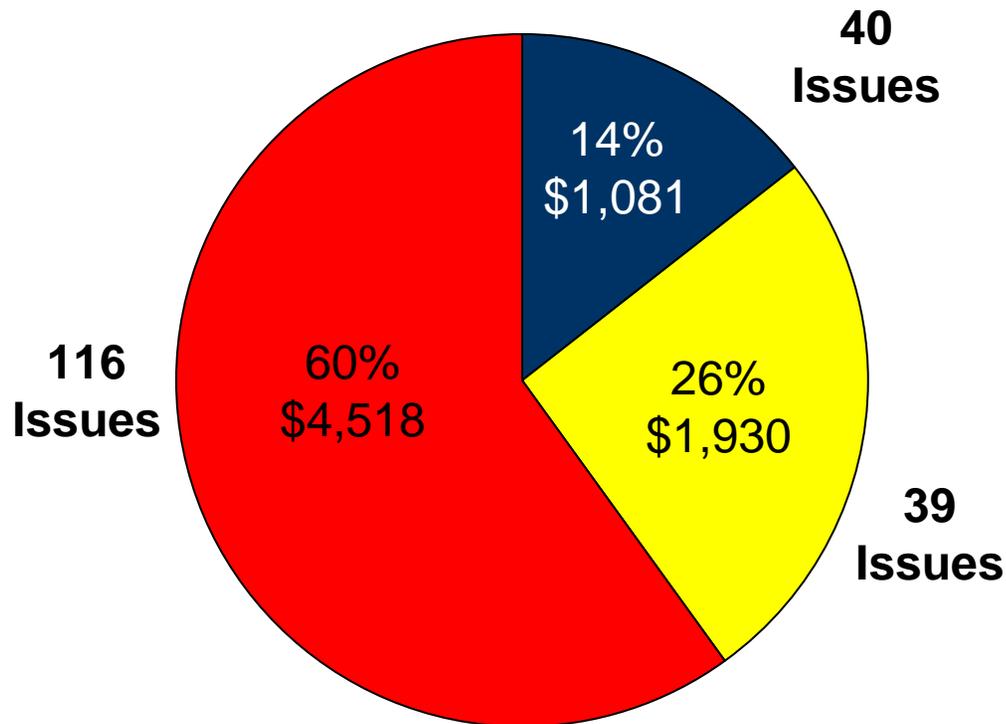
Source: The XYZ's of California School District Debt Financing

Direct Lease

- ❖ Secured by the General Fund - no new revenue source created
- ❖ Not appropriate to finance O&M expenses
- ❖ Funding process can be completed in 30 days

California's 2008 COP Issues

(in \$Millions)



Total Amount: \$7.531 Billion
Total Transactions: 195

K-12 School Facilities

Water Facilities

General Government (1)

Source: California Debt and Investment Advisory Commission (CDIAC)



⁽¹⁾Includes College Facilities, Commercial Development, Convention Center, Equipment, Healthcare Facilities, Multifamily Housing, Multiple Capital Improvements, Parks, Public Building, Recreation Facilities, Solid Waste Recovery Facilities

Certificates of Participation

- ❖ **Certificates of Participation / Lease Financing**
 - **Repaid from General Fund or other available School District resources (no new taxes)**
- ❖ **Allows School District to borrow funds on a long term basis without voter approval**
- ❖ **Secured by lease payments made by School District for the use of facilities or equipment**

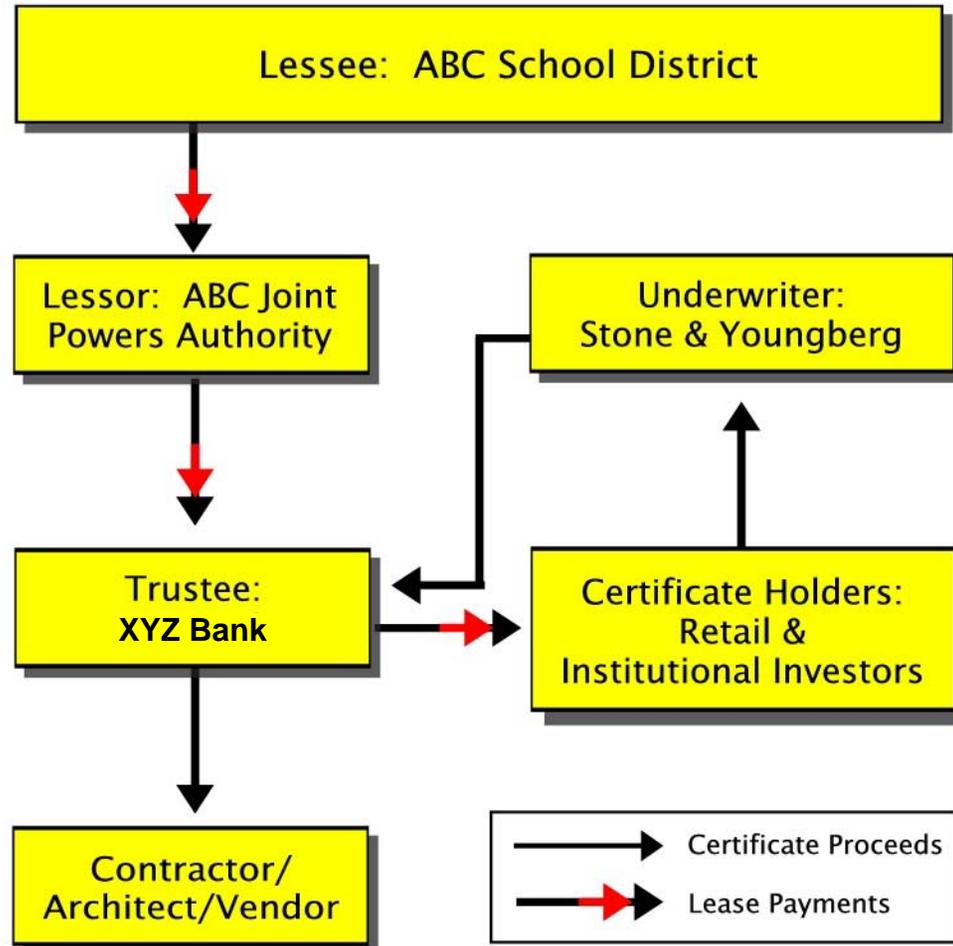
Certificates of Participation

- ❖ **Ideal for construction of school facilities and acquisition of land or refinancing of existing leases**
- ❖ **Utilizes a Lease/Leaseback structure as part of the financing**
- ❖ **Lessee is school district**
- ❖ **Lessor is generally a non-profit financing corporation or joint powers agency / authority**

Certificates of Participation

- ❖ **Lessee (School District) makes semi-annual lease payments for use of leased facility or asset (existing or to be constructed)**
- ❖ **Lessor, (Financing Corporation or JPA) assigns collected lease payments to COP owners (investors) to repay debt**
- ❖ **Trustee (Bank) collects lease payments from Lessor and pays COP owners (Investors) principal and interest due during the term of the lease**

Basic COP Flow of Funds



Certificates of Participation

- ❖ **Repayment / Lease Term equals useful life of leased facility or asset (5-30 years)**
- ❖ **May be structured with a blended pledge of revenues - General Fund, Mello-Roos special taxes and/or redevelopment, tax increment developer fees**
- ❖ **Useful mechanism for interim “bridge financing” prior to receipt of State Funds or issuance of GO bond proceeds**
- ❖ **Can be structured and sold within 90-120 days**

Lease Revenue Bonds

- ❖ **Very similar to COPs (uses, lease term, financing process)**
- ❖ **Issued directly by joint powers authority or non-profit corporation as the lessor**
- ❖ **Useful for pooling financings with different revenue streams (Mello-Roos, leases, RDA revenues)**

Advantages and Disadvantages

ADVANTAGES

- No voter approval required
- Significant flexibility because of fewer procedural and other restrictions
- Can finance virtually any real or personal property
- A lease financing can be completed quickly

DISADVANTAGES

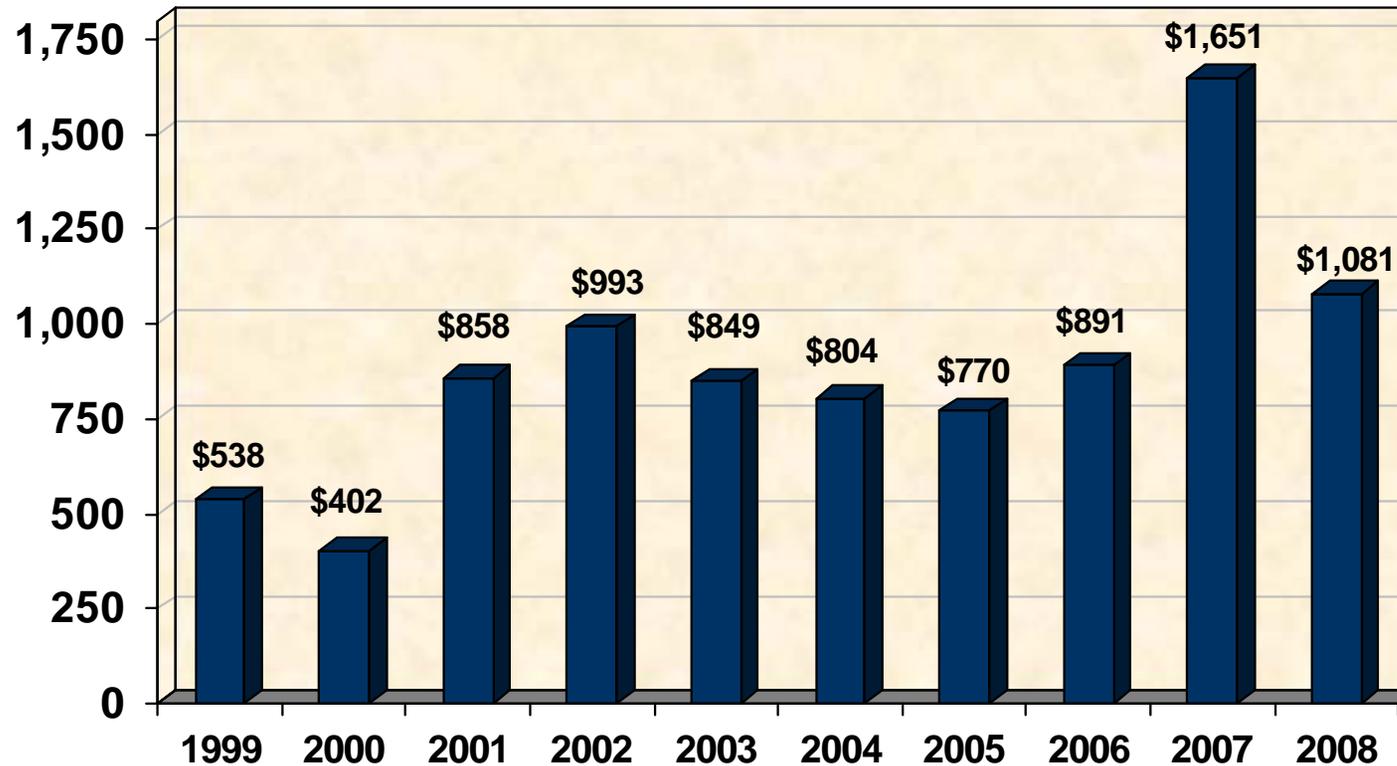
- Does not generate additional revenue to pay debt service
- More complex and less secure than general obligation bonds, interest rates and costs of issuance higher
- COPs/Lease Revenue Bonds require reserve fund for investor security

Annual K-12 COPs Volume

1999-2008

Total Amount: \$8.84 Billion
Total Transactions: 701

\$Millions



40 Issues
in 2008

Lease Financing Legal Considerations

Presented by Robert J. Whalen



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Lease Financing Documents

- ❖ Resolution of Issuance
- ❖ Site Lease
- ❖ Lease
- ❖ Assignment Agreement
- ❖ Indenture or Trust Agreement
- ❖ Bond Purchase Contract or Notice of Sale
- ❖ Official Statement (Preliminary and Final)
- ❖ Continuing Disclosure Agreement or Certificate
- ❖ Credit Enhancement Documents
- ❖ Closing Certificates and Opinions
- ❖ Refunding Escrow Agreement
 - Verification Report
 - Defeasance Opinion

Lease Financing Documents

(continued)

❖ RESOLUTION OF ISSUANCE

- Not to Exceed Amount
- Authorized Officers
- Parameters of Sale
 - ↳ Interest Rate or Savings
 - ↳ Underwriter's Discount
 - ↳ Credit Enhancement
- Compliance with or Waivers of Debt Policies
- CEQA Compliance

Lease Financing Documents

(continued)

❖ LEASE

- Asset Transfer vs. Project Based
 - ↳ Capitalized Interest
 - ↳ Substitution and Release Rights
- Lease Payments
 - ↳ Interest and Principal Components
 - ↳ Variable or Fixed
 - ↳ Frequency
- Abatement
 - ↳ Payments only if beneficial use and occupancy
 - Completion risk
 - Loss of use

Lease Financing Documents

(continued)

❖ LEASE

➤ Insurance

- Types (liability, hazard, title, rental interruption, worker's compensation)
- Limits and Deductibles
- Self-Insurance
 - No for rental interruption
 - Adequacy of reserves
 - Credit Enhancer approval

Lease Financing Documents

(continued)

❖ LEASE

- Prepayment
 - ↳ Ties to Trust Agreement
- Remedies
 - ↳ Re-enter and re-let
 - ↳ Terminate or Continue
 - ↳ Damages
- Tax Covenants
- Restrictions on Use of Facility

Lease Financing Documents

(continued)

❖ ASSIGNMENT AGREEMENT

- Assign rights under Lease to Trustee

❖ TRUST AGREEMENT

- Project Fund Requisition Process
- Prepayment or Redemption Terms
 - ↘ Optional
 - ↘ Extraordinary
 - ↘ Sinking Fund

Lease Financing Documents

(continued)

❖ TRUST AGREEMENT

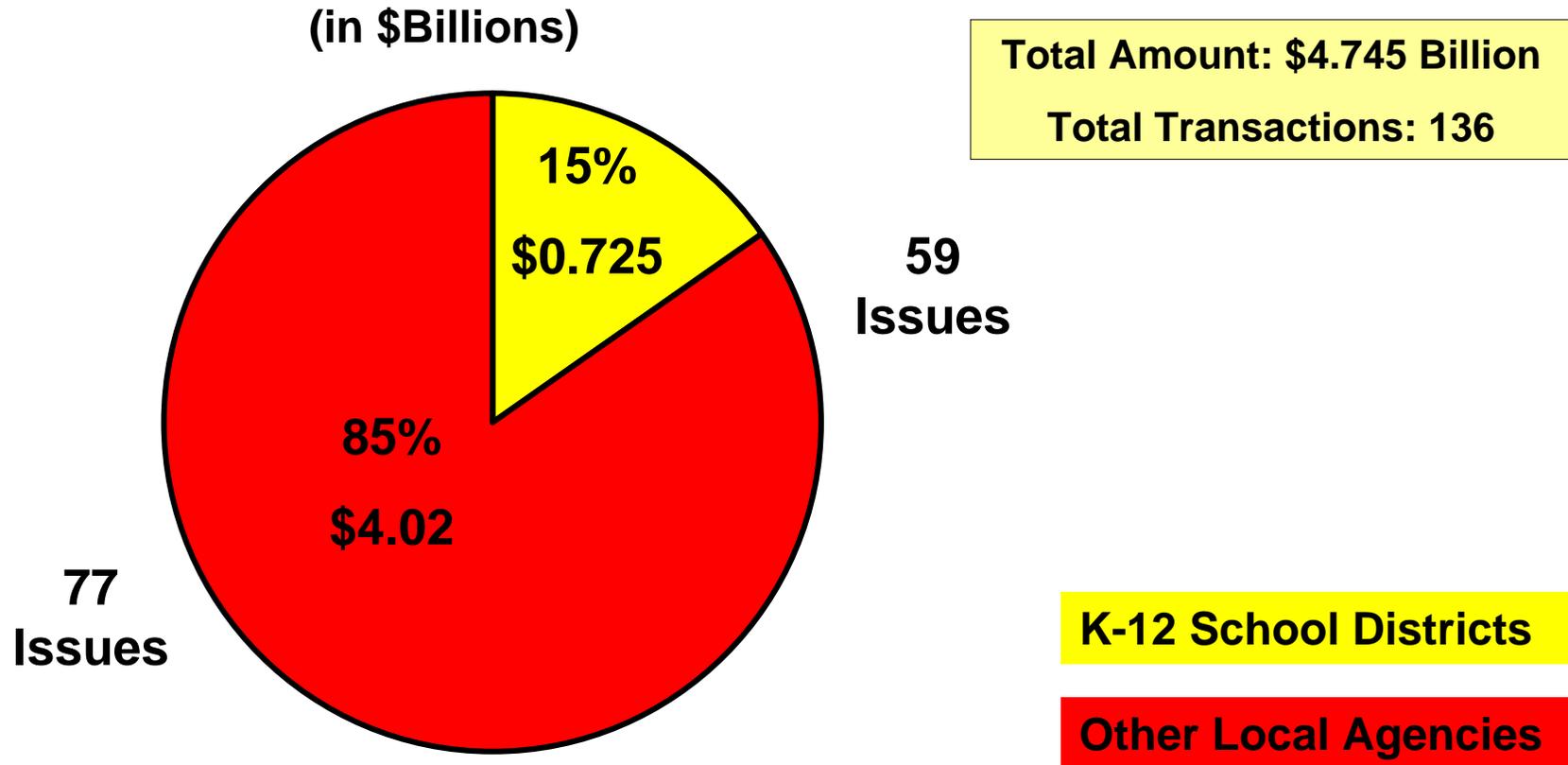
- Investment of Funds
 - ↘ Permitted Investments
 - ↘ Who directs

- Amendment Process
 - ↘ With Bondowners' Consent
 - ↘ Without Bondowners' Consent

- Defeasance
 - ↘ Permitted security
 - ↘ Defeasance opinion
 - ↘ Verification Report

Tax and Revenue Anticipation Notes ("TRANS")

California's 2008 TRAN Issues



What are TRANs?

❖ What is it? Short term borrowing

- Maximum 13 months
- May be tax-exempt or taxable
- Must be repaid from revenues of the same fiscal year; repayment set-asides made during the year

❖ What is it used for? To provide working capital and ease cash flow fluctuations during the year

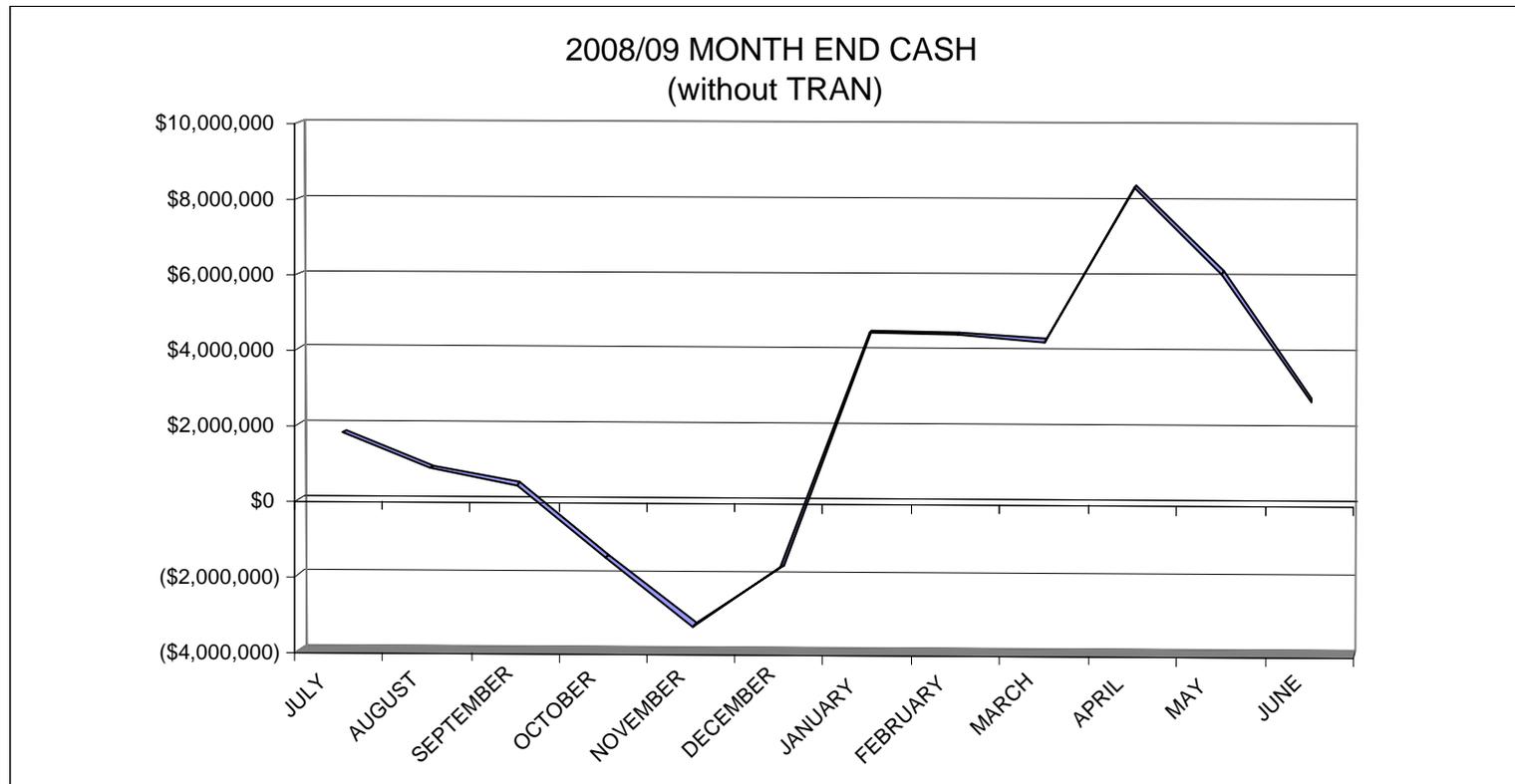
- Sized to cover maximum cash flow deficit
- May be used for current expenses, capital expenditures and investment and reimbursement
- May be able to keep arbitrage earnings

How Do TRANs Work?

- ❖ **No voter approval required**
- ❖ **Require school board and county board approval, ratings (or credit enhancements) and disclosure**
- ❖ ***Alternative:* Borrow from the County Treasurer in negative months with no opportunity to earn interest in positive months, and pay Treasurer higher interest rate on borrowed funds than TRAN rates**

How is TRAN Amount Determined?

- ❖ Amount borrowed tied to anticipated cash deficit and reasonable reserves



TRAN Earnings Example

Estimating TRAN Earnings

Net Proceeds	Original Par Amount	\$	5,000,000.00
	Plus Premium		30,000.00
	Less Costs	0.40%	<u>(20,000.00)</u>
	Net Proceeds		5,010,000.00
	Interest Earnings	5.00%	250,500.00
Net Repayment	Principal Due		5,000,000.00
	Interest Due	4.00%	<u>200,000.00</u>
	Net Payment		5,200,000.00
Net Benefit	Net Proceeds		5,010,000.00
	Net Earnings		250,500.00
	Net Payment		<u>(5,200,000.00)</u>
	Net Benefit		\$ 60,500.00

IRS Rules

- ❖ **Need for TRAN – reasonable expectation of cashflow deficit**
 - **Cashflow based on prior year experience**
 - **Reliable beginning cash and AR/AP numbers**

- ❖ **No arbitrage – excess earnings should be repaid to IRS, unless:**
 - **Small issuer**
 - **Large issuers (6-month exemption only)**

Things to Keep In Mind

- ❖ **Reasonable Expectations about cash needs should be documented**
- ❖ **If other funds are available, may not be able to issue TRAN (Special Reserve, Developer Fees, etc.)**
- ❖ **Actual cash position on deep deficit date should be printed out and filed with TRAN papers**
- ❖ **If deficit is not hit, consider arbitrage rebate calculation (within 60 days of TRAN repayment) and pay back any arbitrage earnings to IRS**

Advantages and Disadvantages

ADVANTAGES

- > No voter approval required
- > Source of funds for temporary cash deficits
- > Only borrowing method for working capital authorized by statute
- > Simple and inexpensive – State and County Pools
- > May permit arbitrage earnings to be kept

DISADVANTAGES

- > Generates no additional revenue (except permitted arbitrage earnings)
- > Size of borrowing is restricted
- > Only revenues received or attributable to the fiscal year in which the TRANS are issued may be pledged for repayment

Annual K-12 TRAN Volume

1999-2008

Total Amount: \$55.9 Billion

Total Transactions: 4,513

\$Millions

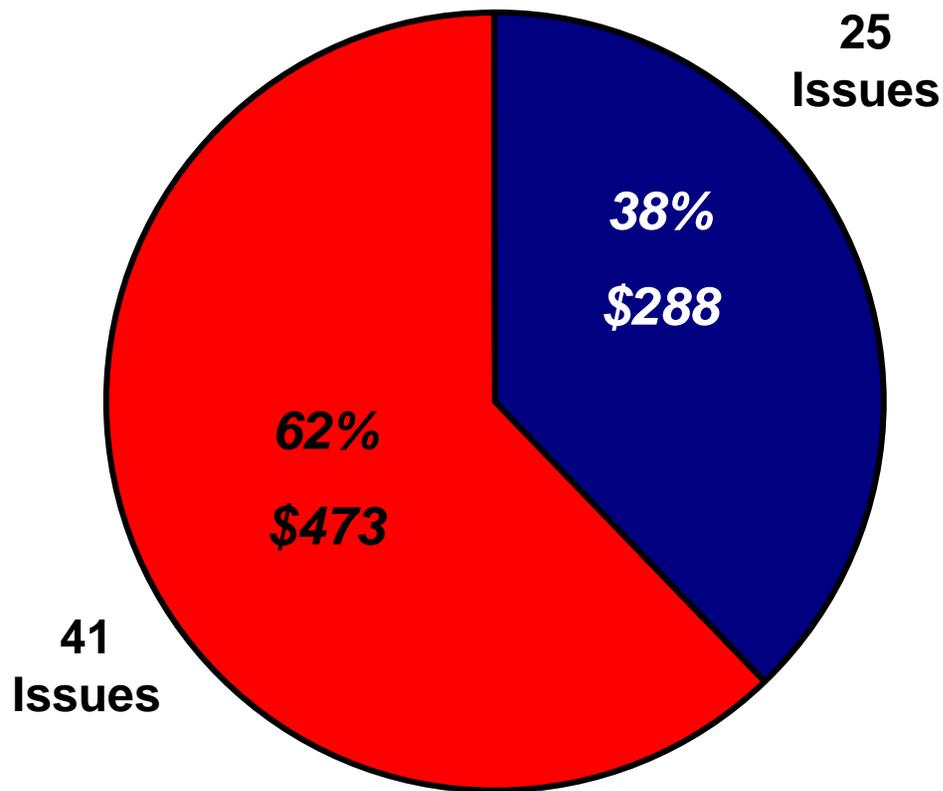


59
Issues
In 2008

Mello-Roos Special Tax Bonds

California's 2008 Mello-Roos Issues

(in \$Millions)



Total Amount: \$761 Million

Total Transactions: 66

General Government (1)

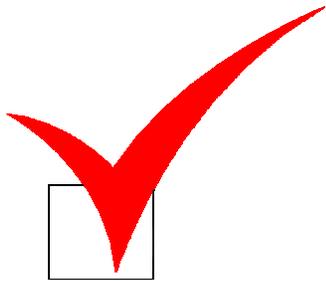
K-12 School Facilities

(1)Includes: Bridges & Highways, Multiple Capital Projects, Parking, Public Building, Street Construction & Improvements, Water Supply, Storage & Distribution, and Wastewater Collection and Treatment

Source: California Debt and Investment Advisory Commission (CDIAC)

What is Mello-Roos?

- ❖ Senator Henry Mello and Assemblyman Mike Roos co-authored the Mello-Roos Community Facilities District Act of 1982
- ❖ The Act authorizes the creation of community facilities districts (“CFD”), levy of special taxes and issuance of special tax bonds
- ❖ CFDs are voter approved (landowner or registered voter) and create new tax revenues



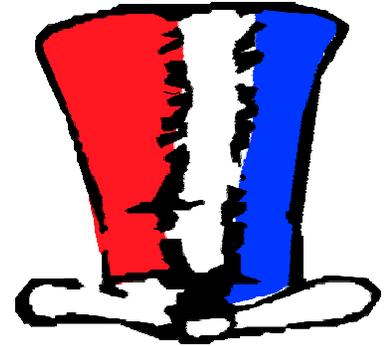
A Mello-Roos Community Facilities District



2007 Aerial Portraits dated (boundaries shown are approximate)

Mello-Roos/CFD Formation

- ❖ **2/3's voter approval required for CFD formation**
- ❖ **Elections are conducted based upon:**
 - **One vote per acre – landowner CFDs**
 - **Registered voter election – 12+ voters in CFD**



Mello-Roos Special Taxes

- ❖ **Special taxes levied within a specific geographic area**
- ❖ **Special taxes levied according to Rate and Method of Apportionment (RMA)**
- ❖ **The RMA sets forth manner in which special taxes are levied (e.g. per acre, parcel, building square footage or zoning designation)**



Mello-Roos Special Taxes and Bonds

❖ May fund a wide variety of projects, fees and services

- Land acquisition
- Relocatable structures
- Building construction and improvements
- Recreational programs and library services
- Developer fees
- Furniture
- School buses
- Equipment (5 year useful life)

Mello-Roos Formation Steps

❖ Step 1

Adopt Goals and Policies

❖ Step 2

Mitigation Agreement with Landowner

Petition by Landowner

❖ Step 3

Resolution of Intention to Form a Community
Facilities District

Resolution of Intention to Incur Bonded
Indebtedness

Mello-Roos Formation Steps

❖ Step 4

Approve Joint Financing Agreements (if applicable)

Public Hearing

Resolution of Formation/Calling Election

Resolution Incurring Bonded Indebtedness/Calling Election

Resolution Canvassing Votes

First Reading of Ordinance

❖ Step 5

Second Reading of Ordinance

Record Notice of Special Tax Lien

Mello-Roos Formation Steps

❖ Step 6

End of Challenge Period

Appraisal of Property (3:1 Ratio)

Prepare Financing Documents

❖ Step 7

Resolution Approving Bond Sale and Financing Documents

Sell and Close Special Tax Bonds

Mello-Roos Special Tax Bonds



- ❖ **Special Tax Bonds are secured by special taxes levied on property with a CFD**
- ❖ **Long term obligation (generally 25-30 years)**
- ❖ **Typically sold to investors *without* credit ratings**

Standard Security Features

Special taxes levied annually at a minimum of 1.10% of bond's debt service for added investor security

$$\text{Tax} = \$110,000 \quad \text{Debt Service} = \$100,000 \quad \text{Surplus/Coverage} = \$10,000$$

Bonds secured by the special taxes and the taxable land & improvements within the CFD

Bond amount constrained by value to lien ratio

$$\frac{\$9,000,000 \text{ (Land Value)}}{\$3,000,000 \text{ (Bonds)}} = 3 \quad \text{(value) :1 (lien) Value to Lien Ratio}$$

Reserve Fund funded with bond proceeds to provide added investor security

Foreclosure Covenant required as remedy to non-payment of special taxes

Advantages and Disadvantages

ADVANTAGES

- > Generates additional revenue to pay debt service, expenses and “pay-as-you-go” facilities
- > Flexibility in establishing RMA
- > Array of facilities can be financed
- > Can match financing needs to new development growth

DISADVANTAGES

- > Lengthy formation/ financing process
- > Higher interest and financing costs
- > Requires annual board approval of tax levy
- > Board may be required to initiate foreclosure on delinquent parcels

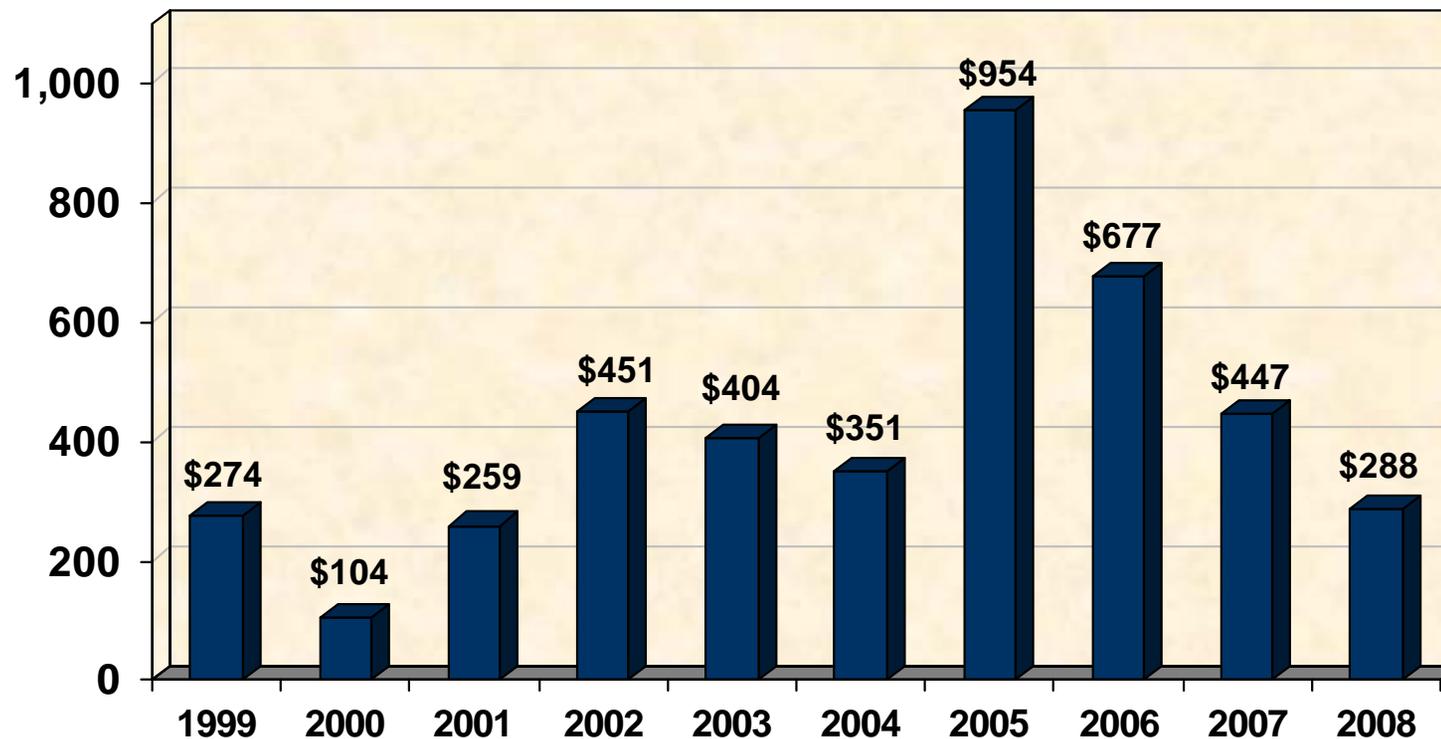
Annual K-12 Mello-Roos Bond Volume

1999-2008

Total Amount: \$4.17 Billion

Total Transactions: 378

\$Millions



25
Issues
In 2008



Disclosure

Presented by Robert J. Whalen



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Disclosure Due Diligence

- ❖ Federal Securities Laws
 - Section 17(a) of 1933 Act – Antifraud Provisions
 - Rule 10b-5 – Antifraud Provisions

- ❖ Rule 10b5
 - “It shall be unlawful for any person.....
 - (a) To employ any device, scheme or artifice to defraud,
 - (b) To make any untrue statement of a *material* fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.....”

Disclosure Due Diligence

(continued)

- ❖ Duty - Disclose all material facts (i.e., facts that are important to an investor in making an informed investment decision) and do not misstate any material facts

- ❖ The “Materiality” Standard
 - “[w]hether or not there is a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest.”

Disclosure Due Diligence

(continued)

- ❖ WHEN DO DISCLOSURE RULES APPLY?
 - New offerings
 - Annual Report under Rule 15c2-12
 - Any other circumstance where an Issuer is “speaking to the market.”

Disclosure Due Diligence

(continued)

❖ Role of Staff:

- Provide information to consultants
- Review drafts of Preliminary Official Statement
- Notify Board members of duty to review and disclose
- Schedule conference call to review draft of Preliminary Official Statement
- Distribute final version of Preliminary Official Statement to Board for review

Disclosure Due Diligence

(continued)

- ❖ Role of Board:
 - Oversight
 - Review draft Preliminary Official Statement
 - Ask questions of staff and consultants
 - Approve distribution of Preliminary Official Statement

Questions for Board to Ask

- ❖ Am I aware of any information about the District that would be important for an investor to know?
- ❖ Is there any pending or threatened litigation against the District that could have a negative impact on the District's finances or ability to repay the debt?
- ❖ Are there any circumstances that exist or that are now unfolding that could place a demand on District reserves or create budget difficulties for the District?

Disclosure Considerations

- ❖ Tomorrow's "hot topic" may be different than today's
- ❖ Disclosure must evolve to reflect changing circumstances
- ❖ Read the disclosure with "fresh eyes"
- ❖ If you think something may be a concern, raise the issue with colleagues and the working group
- ❖ There are no "stupid questions"

What Can Go Wrong?

- ❖ Main avenue for attacks on disclosure is SEC enforcement
- ❖ SEC has power to bring civil actions or refer to Justice Department for criminal action
- ❖ SEC will bring actions against municipal issuers, also targets other participants

What Can Go Wrong?

(continued)

- ❖ SEC Investigation – fees for lawyers and consultants
- ❖ Adverse publicity
- ❖ Reduced market access
- ❖ May have to impose new procedures and oversight to settle SEC actions

Summary

- ❖ Make sure that responsible officials are familiar with disclosure
- ❖ Review the entire POS
- ❖ Seek information and ask questions of the officials, employees, and professionals who supplied information to be included in the POS
- ❖ Ask follow up questions to determine the reasonableness of any assumptions or estimates that were used in the POS

Official Statement

❖ OFFICIAL STATEMENT

➤ Preliminary vs. Final

- ↘ Preliminary used to market certificates/bonds to potential investors
- ↘ Final delivered to actual purchasers

➤ Issuer's Document

➤ Guidance

- ↘ Federal Securities Law (Rule 15c2-12 and 10b-5)
- ↘ Professional Guidelines (CDIAC, GFOA)

Official Statement

(continued)

- ❖ OFFICIAL STATEMENT
 - Who Prepares?
 - ↳ Disclosure Counsel
 - ↳ Underwriter's Counsel

 - Who Reviews?
 - ↳ Staff
 - ↳ Public Officials
 - Actual Knowledge
 - Reckless Disregard

Official Statement

(continued)

❖ OFFICIAL STATEMENT

➤ Liability

- Issuer strictly liable

- Underwriter

 - “Due diligence” defense - reasonable investigation

➤ Rule 15c2-12

- Deemed Final Preliminary Official Statement

- Permitted Omissions of Pricing Data

Official Statement

(continued)

❖ OFFICIAL STATEMENT

➤ Contents

- Description of Certificates or Bonds
- Security and Sources of Payment
- Estimated Sources and Uses
- The Leased Premises
- The Project
- The Issuer (General Description and Financial Matters)
- Risk Factors
- Continuing Disclosure

Official Statement

(continued)

❖ OFFICIAL STATEMENT

➤ Contents (continued)

↳ Concluding Information

- Tax Matters
- Ratings
- Litigation
- Financial Interests

↳ Appendices

- Economic and Statistical Data re Issuer
- Audited Financials
- Form of Bond Counsel Opinion
- Summary of Legal Documents
- Credit Enhancement

Questions

