

**California Debt and Investment Advisory Commission
and California Association of School Business Officials**

**The ABC's of School Debt Financing
Basic School Debt: Financing Mechanisms – Part 2**

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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**
- ❖ **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 (3-30 years)

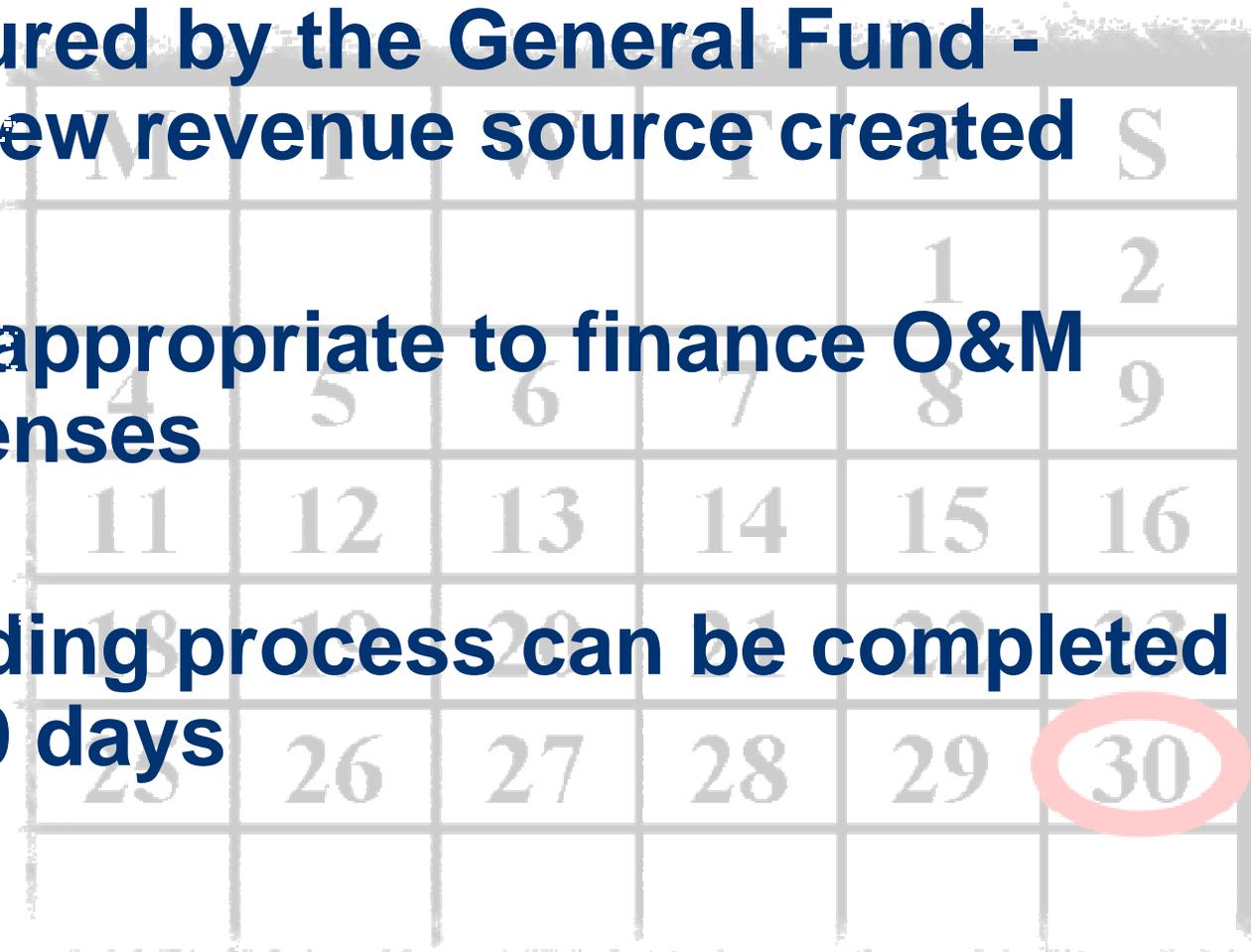
Direct Lease Structure



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

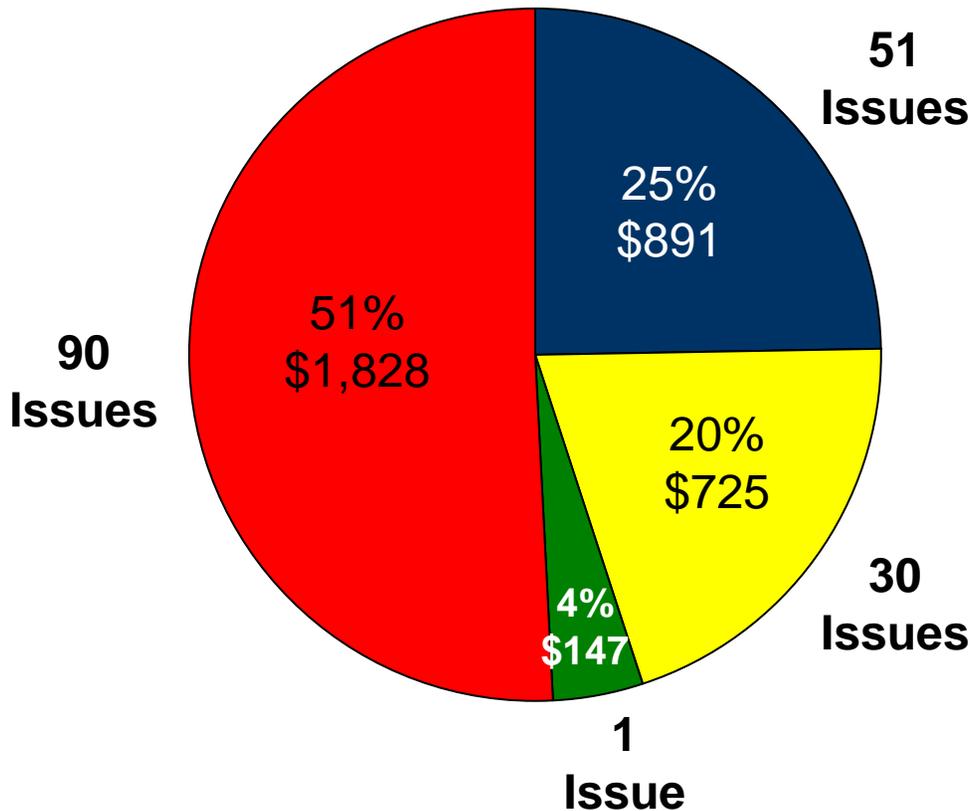
Direct Lease

- ❖ 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 2006 COP Issues

(in \$Millions)



Total Amount: \$3.59 Billion

Total Transactions: 172

K-12 School Facilities

Water Facilities

Public Power

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

California Constitution requires that School Districts may not incur any indebtedness beyond one fiscal year without voter approval

❖ Certificates of Participation / Lease Financing

- Lease obligation not viewed as debt under the California Constitution**
- Repaid from General Fund or other School District resources (no new taxes)**

❖ Allows School District to borrow funds on a long term basis without voter approval

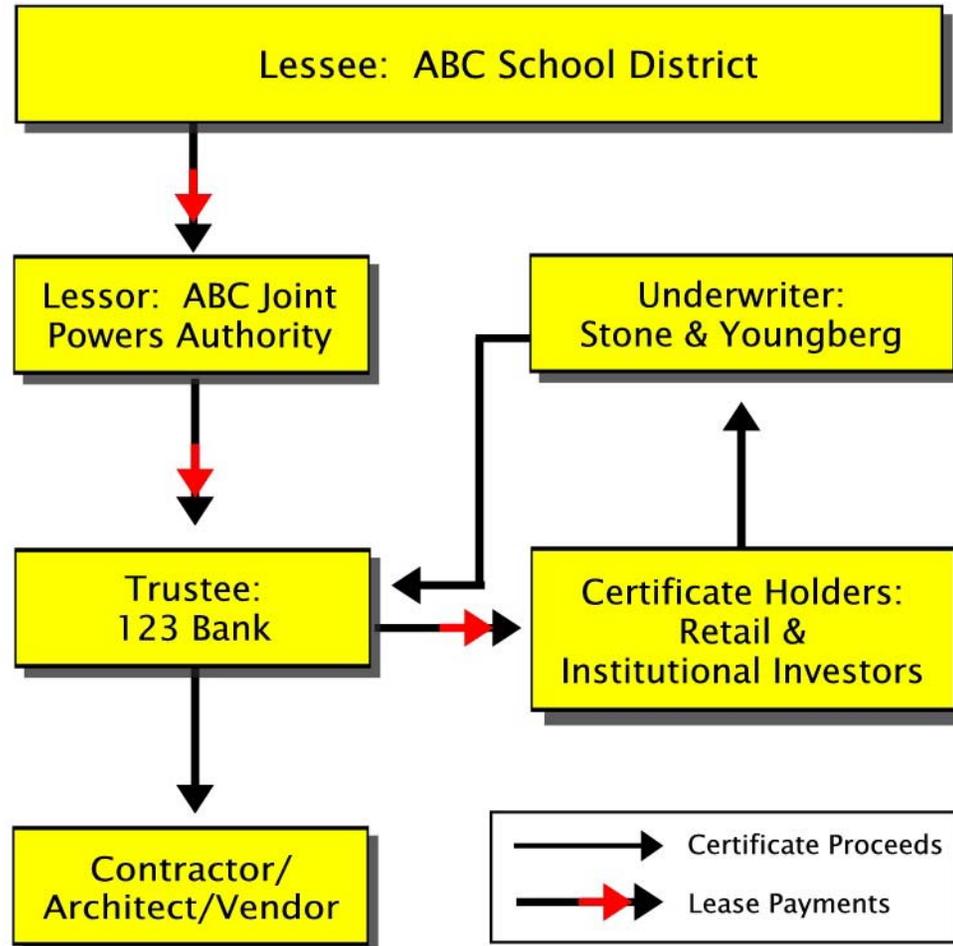
Certificates of Participation

- ❖ **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**
- ❖ **Lessor is generally a non-profit financing corporation or joint powers agency / authority**
- ❖ **Lessee is school district**

Certificates of Participation

- ❖ **Lessee (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 collects lease payments from Lessor and pays COP owners (investors) principal and interest due during the term of the lease**

Basic COP Structure



Certificates of Participation

- ❖ **Repayment / Lease Term equals useful life of leased facility or asset (5-30 years)**
- ❖ **Secured by lease payments made by school district for the use of the facilities or equipment**
- ❖ **Generally secured by the school district's General Fund - no new revenue source is created**

Certificates of Participation

- ❖ **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 “Bridge Financing” prior to receipt of State Funds or GO bond proceeds**
- ❖ **Can be structured and sold within 75 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**

Advantages and Disadvantages

ADVANTAGES

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

DISADVANTAGES

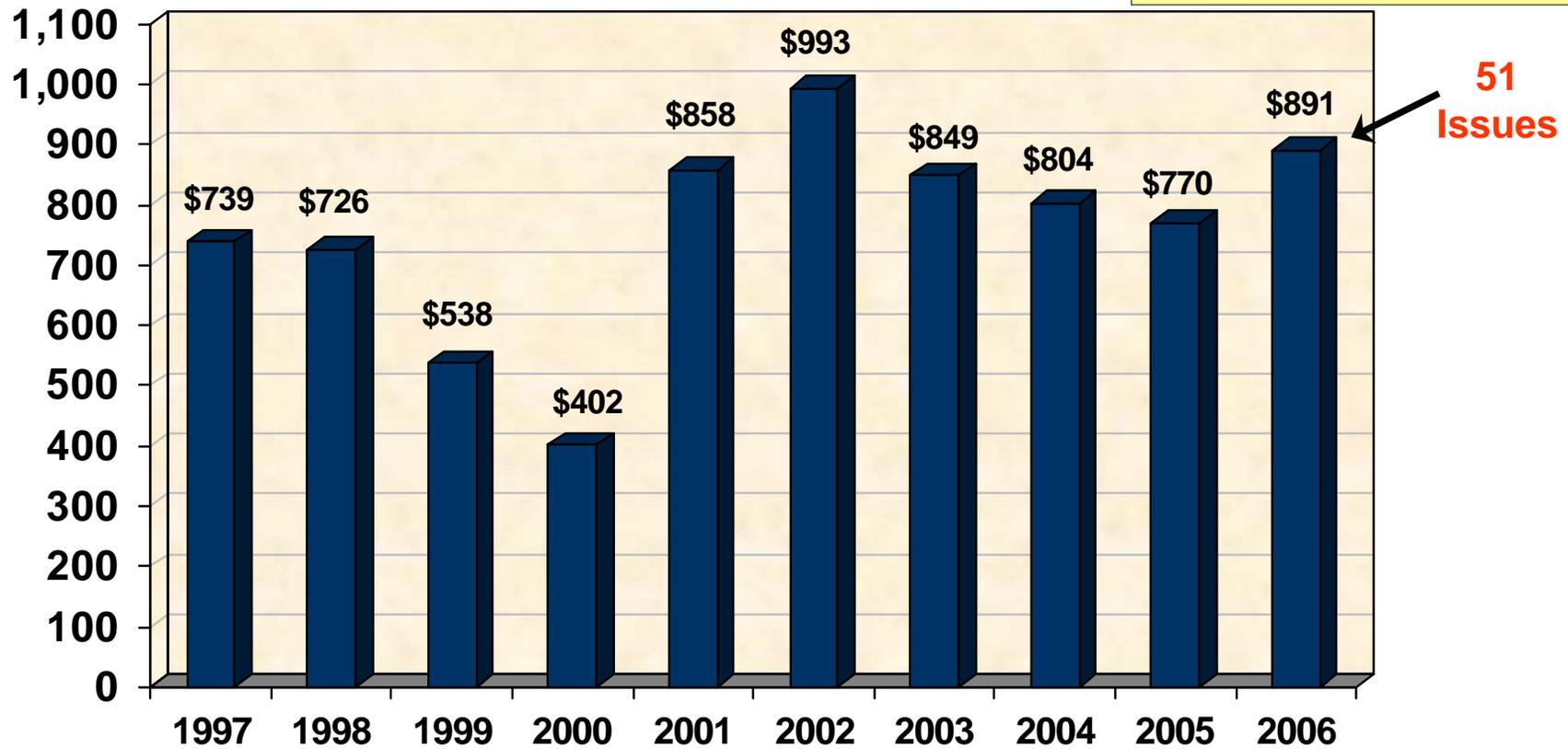
- Does not generate additional revenue to pay debt service
- More complex and less secure than general obligation bonds, interest rates and costs of issuance higher
- COPs/Lease Revenue Bonds require reserve fund for investor security

Annual K-12 COPs Volume

1997-2006

Total Amount: \$7.6 Billion
Total Transactions: 589

\$Millions



Source: California Debt and Investment Advisory Commission (CDIAC)

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

Lease Financing Documents

(continued)

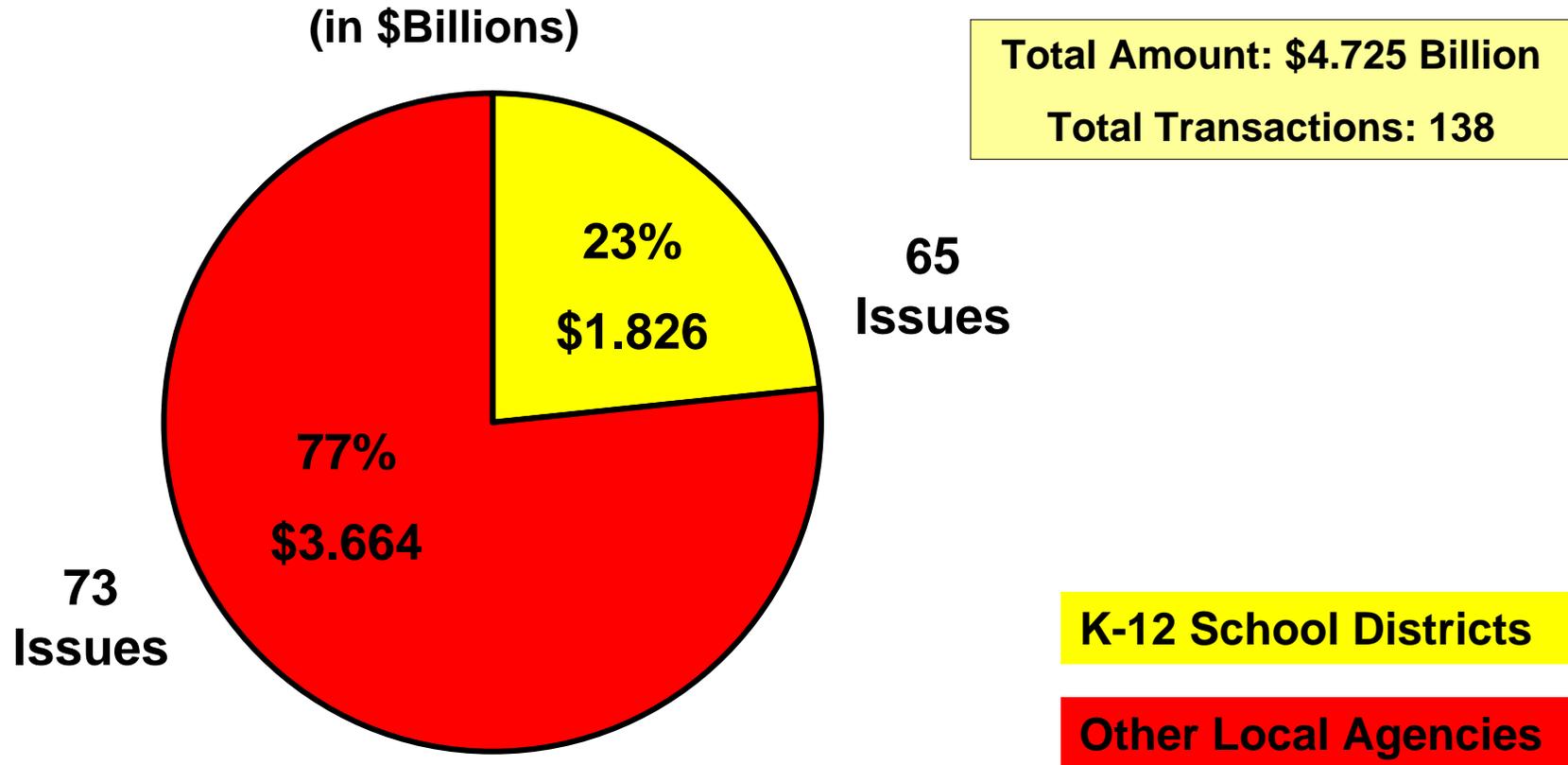
❖ TRUST AGREEMENT

➤ Defeasance

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

Tax and Revenue Anticipation Notes ("TRANS")

California's 2006 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

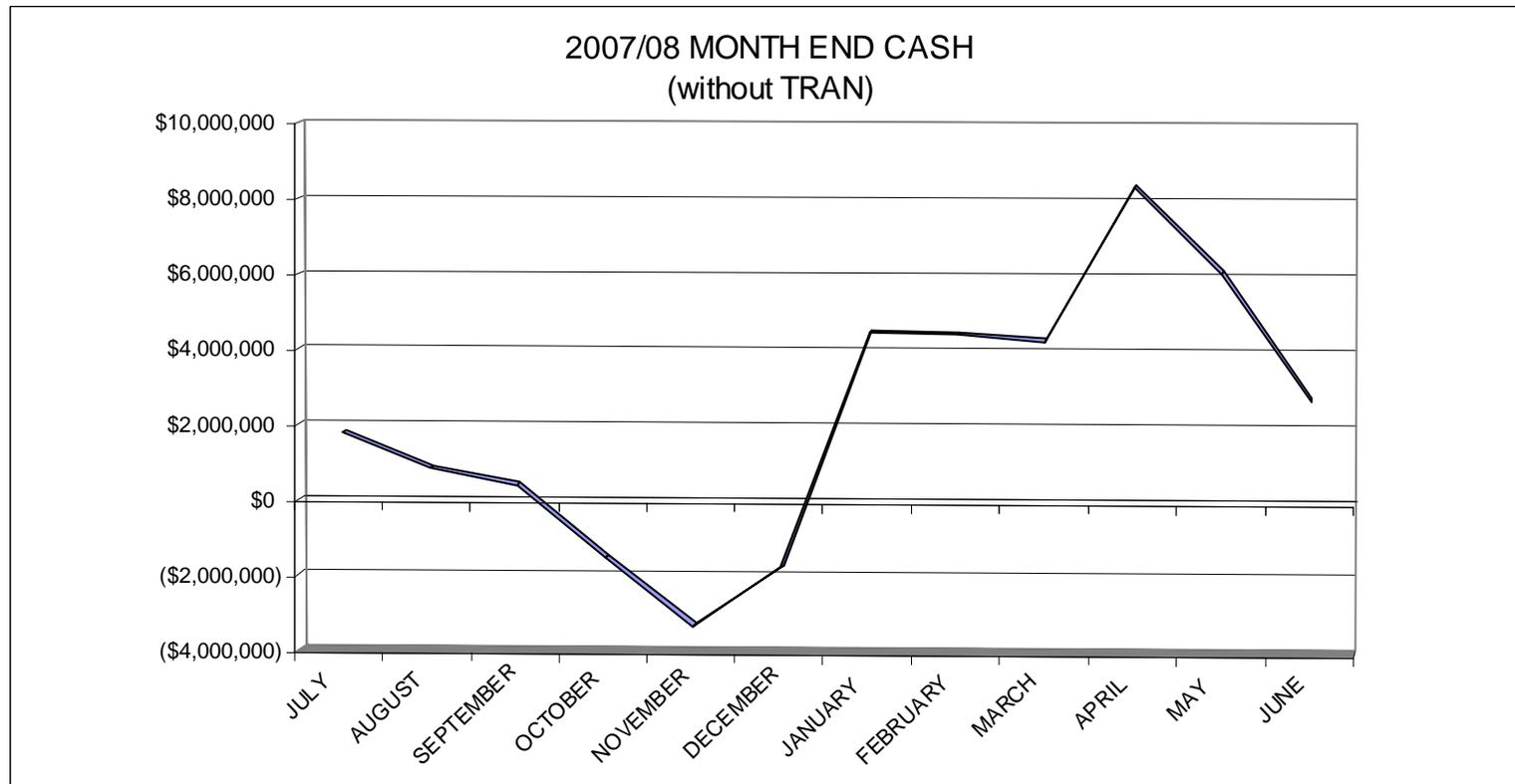
- Sized to cover maximum cash flow deficit
- May be used for current expenses, capital expenditures and investment and reimbursement
- May be able to keep arbitrage earnings

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

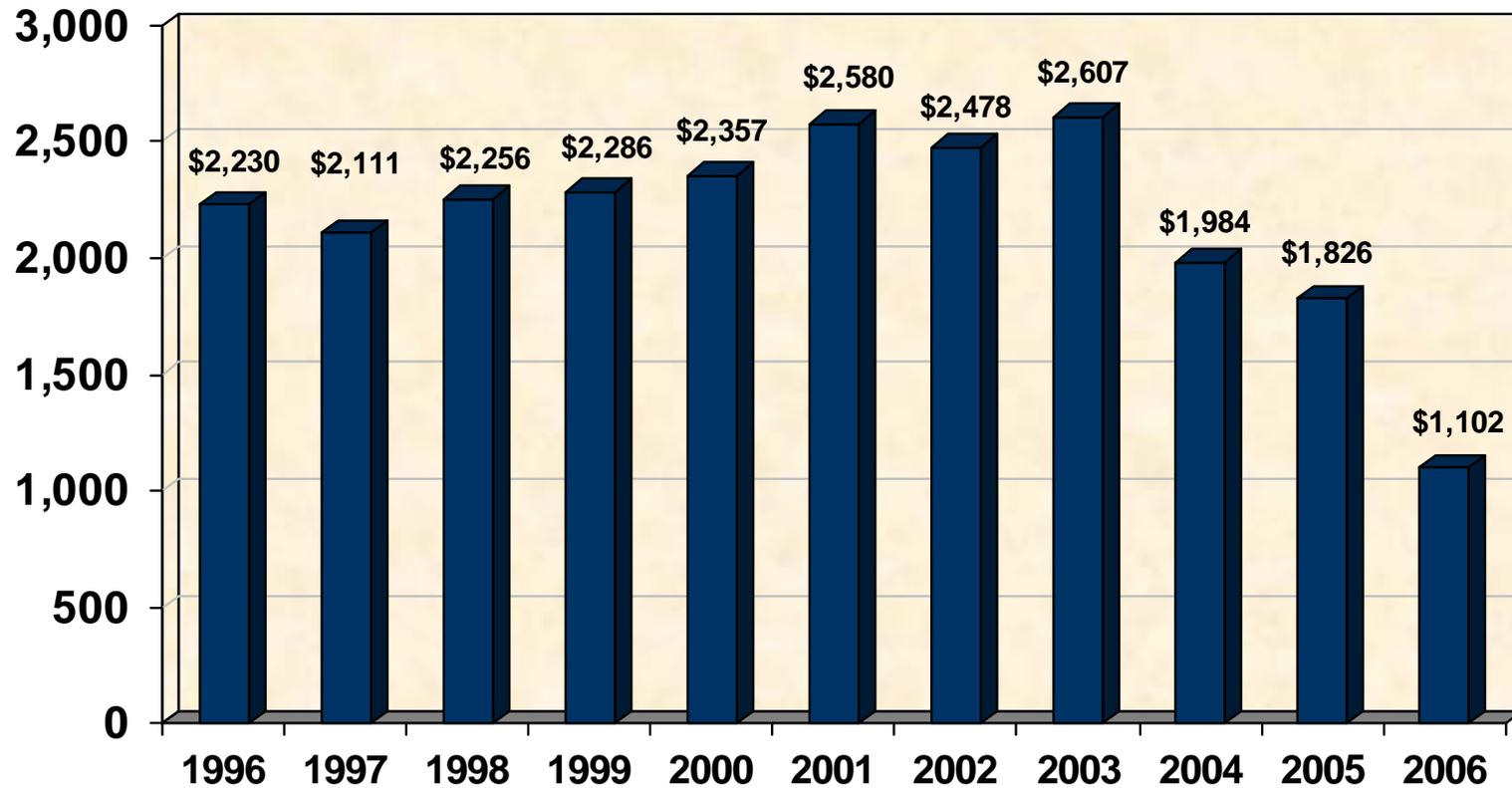
Annual K-12 TRAN Volume

1996-2006

Total Amount: \$23.6 Billion

Total Transactions: 4,632

\$Millions

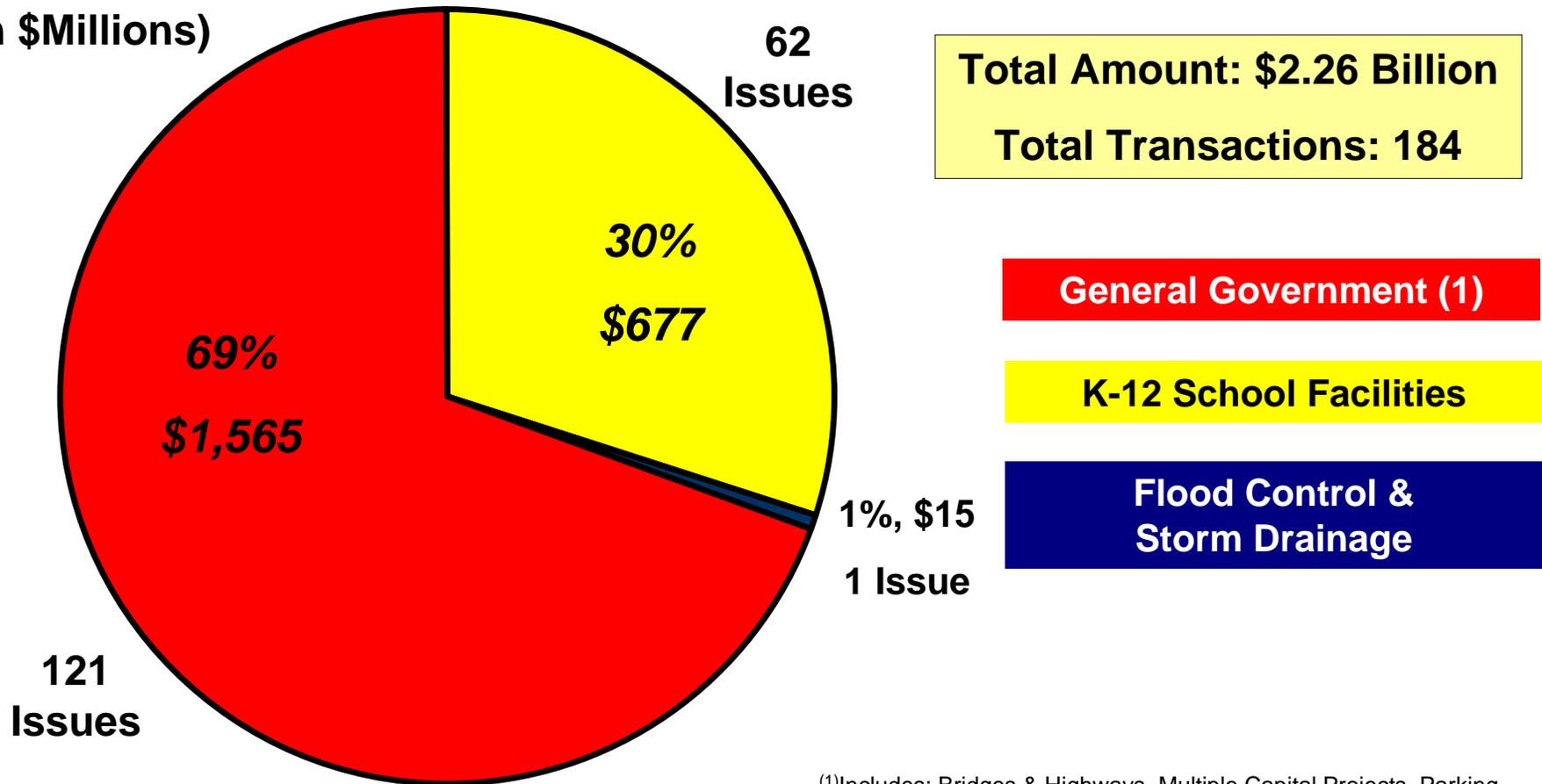


65
Issues

Mello-Roos Special Tax Bonds

California's 2006 Mello-Roos Issues

(in \$Millions)

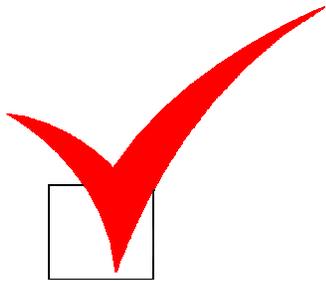


(1)Includes: Bridges & Highways, Multiple Capital Projects, Parking, Public Building, Street Construction & Improvements, Water Supply, Storage & Distribution, and Wastewater Collection and Treatment

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



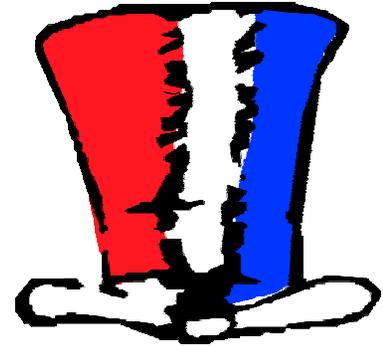
A Mello-Roos Community Facilities District



2007 Aerial Portraits dated 09.13.07 (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 Special Tax Bonds



- ❖ **Special Tax Bonds are secured by special taxes levied within CFDs**
- ❖ **Long term obligation (up to 40 years)**
- ❖ **Generally sold to investors without credit ratings or credit enhancement**

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

Special Tax Bonds: Current Market

❖ **Borrowing Rates Rising due to:**

- Perceived Development Risk
- Subprime / Creative Financing Fall Out
- Falling Home Prices / Standing Inventory
- Escalating Delinquency Rates / Rising Foreclosures / Notices of Default
- Headline News re: Homebuilder Losses
- Lack of trading in secondary market

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
- > May require 2/3 registered voter approval if 12+ registered voters in CFD
- > Requires annual board approval of tax levy
- > Board may be required to initiate foreclosure on delinquent parcels.

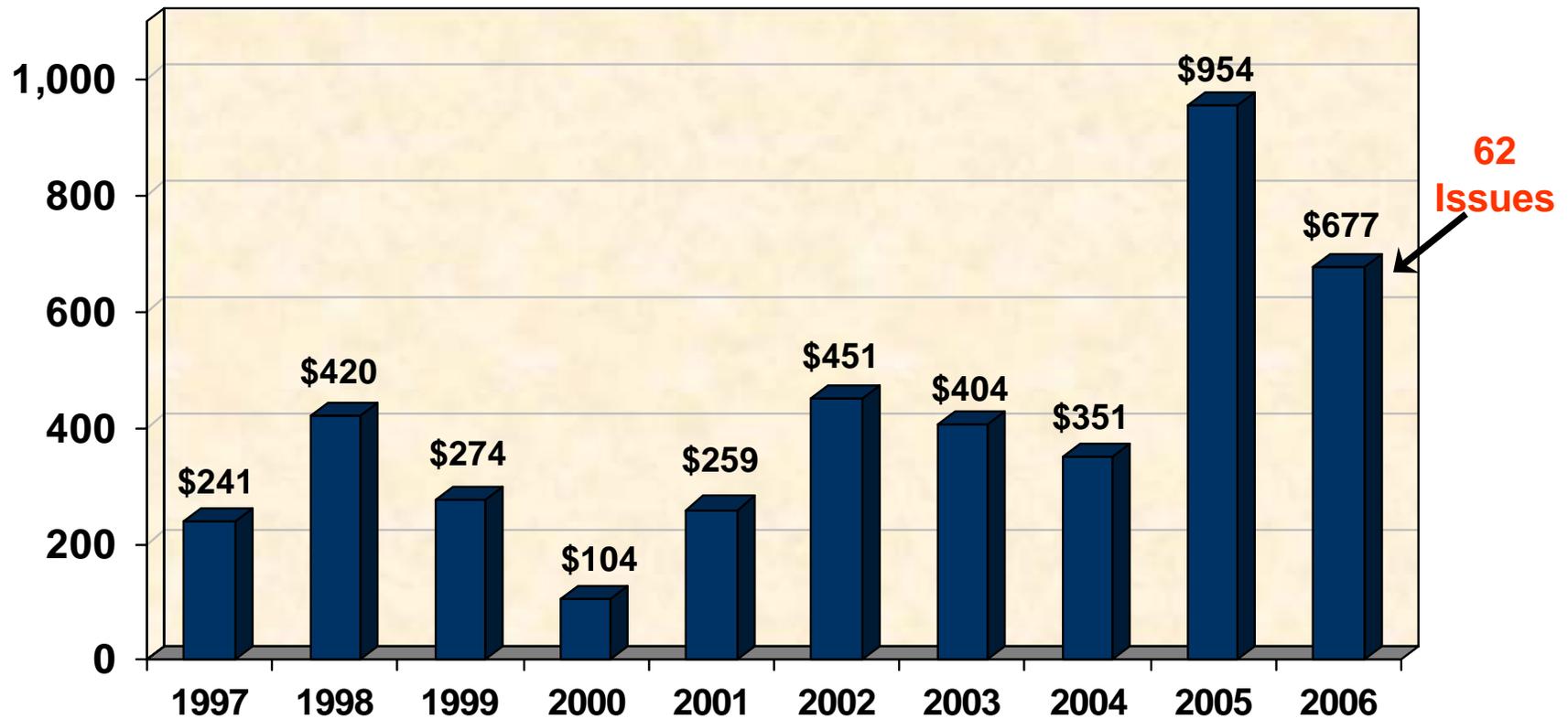
Annual K-12 Mello-Roos Bond Volume

1997-2006

Total Amount: \$4.1 Billion

Total Transactions: 362

\$Millions



Formation and Bond Sale Process

❖ 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

Formation and Bond Sale Process

❖ 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 and Bond Sale Process

❖ 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

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

