

**CALIFORNIA SPECIAL DISTRICTS ASSOCIATION
SANTA BARBARA CHAPTER MEETING**

**FINANCING YOUR DISTRICT'S EQUIPMENT AND CAPITAL
IMPROVEMENT NEEDS**

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I. INTRODUCTION

- A. Financing as alternative to “pay as you go”
 - 1. Financing more expensive
 - 2. Financing provides greater flexibility
 - ◆ Able to adjust repayment schedule
 - ◆ Easier to undertake large projects
 - ◆ Ability to adopt to meet changing needs
 - ◆ Minimize risk of construction cost increases
- B. Basic legal issues
 - 1. Enabling legislation
 - a. Each type of district has different powers
 - ◆ powers to lease or purchase property
 - ◆ power to issue bonds with or without a vote
 - b. Some districts have debt limits
 - ◆ require voter approval
 - ◆ limitations on debt in excess of assessed value
 - 2. Tax issues
 - a. Private use in excess of 5% (or 10% in some cases)
 - b. Requirement to rebate arbitrate earnings
 - ◆ certain exceptions apply (e.g., borrowings less than \$5 million, expenditures within certain time periods)
 - c. Reviewed on case-by-case basis by Bond Counsel

- d. What can be financed on a tax-exempt basis?
 - ◆ generally publicly owned facilities or equipment
 - ◆ generally only projects which can be capitalized, as opposed to working capital (e.g., a copier but not paper, or water rights but not the actual water)
 - ◆ generally must have reasonable expectation that project will be completed within 3 years (exceptions apply)

II. FINANCING ALTERNATIVES

A. General Obligation Bonds

1. Most secure obligation
2. Requires 2/3rds vote of electorate
3. Used only to acquire or improve real property
4. Secured by unlimited *ad valorem* property tax
5. Advantages
 - ◆ Lowest interest cost
 - ◆ Previously unavailable source of revenues (won't detract from other sources available to district)
 - ◆ No reserve fund requirement
6. Disadvantages
 - ◆ Schedule - usually 6 to 9 months or longer depending on election cycle
 - ◆ Difficulty in obtaining 2/3rds vote
 - ◆ Limitations on use of proceeds—capital improvements only
 - ◆ Non-flexible formula for levy - uniform percentage of assessed value

B. Revenue Bonds (see also Revenue-Based COP's below)

1. Generally issued under Revenue Bond Law of 1941
2. Secured by revenue from specific revenue producing enterprise (e.g. water system)
3. Advantages
 - a. Self-sufficient financing for project
 - ◆ No lien on non-enterprise revenue
 - ◆ No obligation of general fund
 - b. Generally considered secure credit
4. Disadvantages
 - a. Requires majority vote
 - b. Issuer obligated to raise rates if revenues not sufficient
 - c. Requires coverage factor of 10-25%
 - d. Limitations on issuance of additional debt secured by revenues

C. Assessment Districts

1. Bonds secured by special assessment levied on property
 - ◆ Property must receive benefit from project
 - ◆ App Property benefited must be included (even public property)
 - ◆ Assessment levied in proportion to benefit received
 - ◆ Not a tax
2. Generally used to finance infrastructure (e.g. roads, parks, sewer and water facilities, other utilities, drainage facilities, streets and lights)
3. Levied after noticed public hearings and with approval of owners of a majority of the property in the proposed assessment district
4. Only certain districts can use 1913 Act
 - ◆ 1913 Act provides broadest powers
 - ◆ District must be authorized by enabling legislation to use 1913 Act
5. Landscaping and Lighting Act of 1972 can be used for parks, playgrounds and open space
 - ◆ Used for community center with vote of property owners
 - ◆ No ability to override majority protest
6. Advantages
 - ◆ Generates additional revenue to district not otherwise available
 - ◆ Not an obligation of issuer
 - ◆ Property benefiting from project pays for it
 - ◆ Commonly accepted method of financing
 - ◆ Allows collection of maintenance assessments
7. Disadvantages
 - ◆ Often politically unpopular
 - ◆ lien placed on property
 - ◆ electorate often confuses assessments with taxes
 - ◆ Generally requires lien-to-value ratio of 3:1
 - ◆ Issuer generally obligated to foreclose on delinquent property owners within 150 days
 - ◆ Requires continued supervision by issuer

D. Mello-Roos Community Facility Districts

1. Bonds secured by special tax annually levied by issuer
 - ◆ No requirement of establishing benefit to property
 - ◆ No gross lien on property
 - ◆ Greater flexibility in structuring and phasing projects, spread of tax and amount of tax over different types of property
2. Used to finance capital facilities with useful life in excess of 5 years

3. Used to finance certain services (e.g., fire, police, library and recreational services)
 4. Special tax approved by 2/3rds vote of electorate following noticed hearings
 - a. Or by owners of 2/3rds of property if less than 12 registered voters
 - b. Majority protest at hearing terminates proceedings for 1 year
 5. Special tax is levied each year in accordance with formula approved at time of formation
 6. Advantages
 - ◆ Very flexible levy; allows phasing of tax and projects
 - ◆ Not an obligation of issuer
 - ◆ Cost of project limited to certain property owners
 - ◆ Allows financing of wide variety of projects and services
 - ◆ Additional revenue source to issuer
 - ◆ No special benefit finding required
 7. Disadvantages
 - ◆ Requires 2/3rds vote
 - ◆ Oftentimes extremely complex
 - ◆ Requires 3:1 lien-to-value ratio
 - ◆ Public relations problem due to secondary market disclosure issues
 - ◆ Generally lengthy schedule
- E. Certificates of Participation (“COP’s”)
1. Financing based on power of district to lease or purchase property
 - a. no voter approval required
 - b. need to review enabling legislation for appropriate powers
 2. Used to finance capital facilities
 3. Lease-based COPs
 - a. Subject of the lease is either facility to be built or acquired or an existing facility
 - b. District leases facility or property to another entity (e.g. a joint powers authority or a finance corporation, such as CSDA Finance Corporation), which leases completed project back to District
 - c. Lease payments assigned to trustee, which issues certificates evidencing right to share in such payments
 - d. Annual payments must be fair rental value
 - e. Annual payments are made from general fund and other legally available funds of District
 - f. Payments abated if project not available for use (e.g. damaged by fire)

- g. Advantages
 - ◆ no voter approval
 - ◆ quick time schedule
 - ◆ flexible structure
 - ◆ finance wide variety of capital improvements (e.g. pipelines, buildings, reservoirs)
 - ◆ Generally available to all Districts
 - h. Disadvantages
 - ◆ general fund obligation
 - ◆ generally viewed as weaker credit
 - ◆ facility is security for financing and subject to encumbrance
 - ◆ abatement risk usually requires rental interruption insurance
 - ◆ not an additional source of income -- is paid from excess available funds of District
 - ◆ requires capitalized interest until project completed
4. Revenue-based COP's
- a. Used to finance facilities related to revenue producing enterprises (e.g. water or sewer systems)
 - b. Repayment limited to specific enterprise revenues
 - c. Installment payments assigned to trustee for distribution to investors
 - d. Advantages
 - ◆ no lien on non-enterprise revenues
 - ◆ secured by rates and charges of enterprise
 - ◆ generally considered secure credit
 - ◆ used for wide variety of facilities
 - ◆ generally viewed as a revenue bond without the necessity of a vote
 - ◆ no capitalized interest required
 - e. Disadvantages
 - ◆ District obligated to raise rates and charges if revenue is insufficient
 - ◆ no abatement
 - ◆ requires coverage factor of 10-25%
 - ◆ limitations on issuance of additional debt
 - ◆ not available to certain Districts because of debt limits in enabling legislation

5. Private Placement
 - a. Leases and Installment Purchase contracts can also be privately placed
 - ◆ Entered into directly with a bank
 - ◆ Primary benefit is speed and ease of documentation
 - ◆ Very useful for smaller borrowings (\$50k-\$1-2 million)
 - ◆ Costs are included in interest rates, so often more expensive over time than public offering

- F. Joint Powers Authority Revenue Bonds
 1. District may join with other governmental agency to form joint powers authority (“JPA”)
 - a. Separate governmental entity
 - b. Powers are same as forming entities
 2. JPA can purchase obligations of other entities or enter into lease or installment purchase agreements
 3. JPA can issue revenue bonds secured by payments made on such obligations or under such agreements
 4. Advantages
 - ◆ Allows pooling of obligations
 - ◆ Greater flexibility in structuring
 5. Disadvantages
 - ◆ Requires District to find another governmental entity to create JPA
 - ◆ Additional administrative requirements for District

- G. Securitized limited Obligation Notes (SLONS)
 1. Created by SB 1770 (effective January 1, 2005) to provide secure short-term financing tool for Special Districts (Gov. Code 53835)
 - ◆ Legislature concerned that existing promissory note authority was “risky business”
 2. Secured by pledge of specific revenues of a District
 - ◆ General Fund cannot be generally pledged, but may be able to carve out certain components of the General Fund
 3. Can be used only for capital improvements
 4. Maximum 10 year maturity
 5. Maximum of \$2 million outstanding at any time
 6. Requires approval by 4/5th’s of the Board of Directors
 7. Authorizing legislation currently set to expire December 31, 2009
 8. Advantages

- ◆ Simpler method of borrowing funds
 - ◆ By pledging specific revenues, may lower borrowing costs
 - ◆ While SLONS can only be used for capital improvements, they can free up other funds for operational costs
9. Disadvantages
- ◆ Limitations on maturity and amount limit usefulness
 - ◆ Still not clear as to how much of a general fund can be pledged

III. GENERAL CONSIDERATIONS

- A. Nature of Project
1. Determines what alternatives are available
 2. Determines what revenue sources are available
- B. Scheduling
1. When is project ready to proceed
 - a. Tax law restricts early issuance of obligations
 - b. Minimize capital interest
 - c. Ensure funds are available when ready to start project
 2. When will revenues be available
 - a. Need for capitalized interest
 - b. Structuring of repayment schedule
 - c. Need to review or increase rates and charges
- C. Type of Financing
1. Fixed rate or variable rate interest
 - a. Variable risk requires credit enhancement
 2. Negotiated sale or competitive bid
- D. Selecting Financing Team
1. Done early in process
 2. Members will vary if negotiated sale or competitive bid

IV. FINANCE TEAM

- A. Issuer
1. Board hires finance team and approves financing
 2. Review by local counsel
- B. Bond Counsel
1. Ensures compliance with state and federal law
 2. Helps structure financing
 3. Primary purpose is to issue opinion interest is tax-exempt
 4. Selected by Issuer
- C. Underwriter

1. Selected by Issuer
 - a. Negotiated sale
 - i. selected by Issuer early in process
 - ii. structures financing and determines best time to enter market
 - iii. generally prepares disclosure document
 - iv. purchases obligations from Issuer and resells to public investors
 - b. Competitive sale
 - i. selected by Issuer after financing is structured
 - ii. agrees to purchase obligations on sale date at established prices
 - iii. resells obligations to public
- D. Placement Agent
 1. Selected by Issuer for private placement of leases or installment purchase contracts
 2. Solicits bids from banks and negotiates terms
 - i. prepares credit package
 3. Often provides documentation for financing
 4. Compensation is usually from fee paid by bank
- E. Trustee/Fiscal Agent
 1. Banking institution which handles administrative functions and pays principal and interest to investors
 2. In some instances, holds and disburses proceeds of the obligations
 3. Invests funds at direction of Issuer
 4. Is the main contact between the Issuer and investors
- F. Financial Advisor
 1. Optional for negotiated sales, mandatory for competitive sales
 2. Selected by Issuer
 3. In competitive sale, prepares the disclosure document and solicits bids from underwriters
 4. Advises Issuer on pricing and timing issues
 5. Reviews creditworthiness of transaction and Issuer
- G. Rating Agency
 1. If involved, reviews underlying credit of transaction
 2. Assigns rating to obligations, which affects interest
- H. Credit Enhancement Provider
 1. Guarantees or insures repayment of obligation by Issuer
 2. Results in lower interest rates

3. Must result in overall savings to Issuer or not allowed by tax code