CLIENT NEWS BRIEF

New Legislation Imposes Greater Transparency Requirements and Structuring Limitations on General Obligation Bond Financings for California School Districts and Community Colleges

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In response to recent negative media attention and heightened political scrutiny of some local agency bonds, Governor Jerry Brown signed important public finance legislation on October 2, 2013. Assembly Bill (AB) 182, effective January 1, 2014, places certain restrictions on the issuance of bonds by school districts and community colleges. As we have brought to your attention in a prior Client News Brief, AB 182 primarily addresses controversial issues concerning the use of bonds that allow for the compounding of interest, including capital appreciation bonds (CABs), to pay for K-12 and community college district facilities construction projects. AB 182 also impacts school district and community college issuance of "current interest bonds" – bonds on which interest is paid to bond holders periodically during the life of the bond to maturity, without compounding. As we have observed since AB 182 was first proposed, several issuers have accelerated their financing timetables to issue bonds before the effective date of AB 182.

As opposed to current interest bonds, CABs are sold at an initial principal value and "accrete" to final principal value at maturity. This structure effectively defers payment of interest and principal during the early life of the CAB and pays bond holders at a later date, typically at maturity. Deferment of payment is often required or desirable for districts that have reached debt service capacity in the near-term. The trade-off for the deferment afforded with CABs is that the effective yield on CABs is often much higher than on current interest bonds. Critics of CABs, including State Treasurer Bill Lockyer and State Superintendent of Public Instruction Tom Torlakson, have pointed to a handful of what have become high-profile financings in the San Diego area where, due to the interest rate and length of term, the total debt service to initial principal ratio was ten-to-one or higher.

Under current law, school districts and community college districts can issue bonds under the Government Code with a maturity of up to 40 years and with an interest rate of up to 12%. Additionally, under current law, CABs are not required to have a redemption or tender feature (known as a "call right"). Such a call right gives the issuer more flexibility, allowing the issuer of the bond to pay and redeem the bond at a time earlier than final maturity by payment of the outstanding principal amount (and premium, if any), together with interest accrued or, in the case of CABs, any principal accreted, to the date fixed for early redemption or tender. AB 182 limits the way school districts and community college districts may finance their school facilities projects through issuance of general obligation bonds, including placing stricter limits on bond maturity and bond interest rates, mandating debt service-to-principal ratios and mandating redemption or tender for purchase.

Although the final legislation is not as restrictive as when the bill was first introduced, AB 182 will do the following, effective January 1, 2014:

- Limit all CABs to a maximum term of 25 years and 8% interest.

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- Require all CABs with a term longer than 10 years have a call right no later than 10 years from issuance.

- Limit the ratio of total debt service to principal to no more than 4:1 on each bond series.

- Require public disclosure of detailed information about any proposed use of CABs, including but not limited to financing terms and time of maturity, repayment ratio, and estimated change in assessed value of property in the district over the financing term.

- Require that if the bond sale will include CABs, then the board resolution approving the sale must be presented to the governing board on two consecutive meeting agendas, first as an informational item, and second as an action item.

- Require that the agenda item for any bond sale, including a CAB, identify if a CAB is proposed and state that the governing board be presented with all of the following: (i) disclosure of the financing term and time of maturity, repayment ratio, and the estimated change in the assessed value of taxable property within the school district or community college district over the term of the bonds; (ii) an analysis containing the total overall cost of the CAB; (iii) a comparison to the overall cost of current interest bonds; (iv) the reason CABs are being recommended; and (v) a copy of the written disclosure made by the underwriter to the district in compliance with Rule G-17 adopted by the federal Municipal Securities Rulemaking Board.

- Require current interest bonds with a maturity greater than 30 years to comply with the disclosures required of CABs, as discussed above, and further require that the governing board make a finding that the useful life of the facility funded by the current interest bond will equal or exceed the maturity date of the current interest bond.

- Authorize a one-time waiver to the provisions of AB 182 for any bonds issued by a school district or community college solely for the purpose of retiring bond anticipation notes issued prior to December 31, 2013.

Good business practice dictates that school district and community college administrators and governing boards are adequately advised by their financial advisors, bond counsel and other members of the financing team regarding all available financing options in order to promote informed decision making and provide public transparency. It is always a good idea to ask your financial advisor to give a presentation on financing options and proposed terms, including an overview of the proposed financing structure, advantages of one financing vehicle over another (e.g., CABs versus current interest bonds), likely debt service to principal ratios, proposed call features, and likely interest rates and maturities.

If you have any questions regarding bonds, please feel free to contact one of our eight offices located statewide. You can also visit our website, follow us on Facebook or Twitter, or download our Client News Brief App.

