From Sacramento With Love: Impending Bond Legislation

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An old axiom among attorneys is that bad facts make bad law. In politics a small sample of extreme circumstances may lead to sympathetic legislators making a law that seems to redress one inequity, but in turn has negative and usually unintended consequences for society. Sometimes an extreme set of facts can push the pendulum too far.

Due to a great deal of media attention in recent months, the Legislature seems poised to take action to limit the way school districts, small and large, finance their local match for needed school housing projects, even as many school district languish on the State Allocation Board's unfunded approved list.

The target of the hour is capital appreciation bonds ("CABs"). Under the bond law, an elementary school district or high school district may assess taxes to service bond debt at a maximum of $30 per $100,000 of assessed value of real property in the school district; a unified school district's limit is double that, or $60 per $100,000 of assessed value. Under the Government Code, the interest rate on bonds may not exceed 12% and the maturity may not exceed 40 years. As opposed to current interest bonds, on which interest is paid to bond holders during the life of the bond to maturity, CABs defer payment of interest and principal during the early life of the bond, paying bond holders at a later date. The exchange for the deferment in this structure is interest rates are typically higher than current interest bonds.

Critics of CABs point 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 payback ratio was anywhere from approximately seven to nine times the amount borrowed.

And so, we are told to expect legislation within the upcoming weeks addressing school districts' ability to issue CABs, including a bill by Assembly Member Ben Hueso. Although at the time of this writing the bill has not yet been introduced, his proposal is likely to:

- Limit the maturity of all bonds to 25 years;
- Reduce the maximum interest rate on all bonds to eight percent;
- Limit the payback ratio to four-to-one;
- Require early prepayment provisions ("call features") on all bonds; and
- Require the county board of supervisors or county superintendent of schools to approve bonds for school districts before issuance.

School district advocates, including the California School Boards Association ("CSBA"), are working on alternative, less drastic proposals aimed at maintaining some flexibility and transparency. CSBA's proposal would allow the tax rate limits of $30 and $60 to be calculated as an average across the life of the bond, from issuance to maturity. In addition, the proposal would allow for greater transparency regarding the terms of the proposed structure of the intended financing than is now required. Such changes are intended to ensure the community is notified of the terms of the financing considered by school districts and ensure ample time for community review and comment.

Whether any of these changes come to pass, good business practice dictates that school district administrators and governing boards are adequately advised by their financial advisors and other members of the financing team regarding any financing structure so that informed decisions are made. It is often a good idea to ask your financial advisor to give a presentation on financing options and proposed terms. Some items to think about:

- The proposed structure of the financing, current interest bonds and CABs, or one or the other;
- Advantages and disadvantages of current interest bonds and CABs;
- Call features;
- Likely interest rates and maturities for each component of the financing; and
- Likely payback ratios.

It is unclear what the Legislature will ultimately have in store for CABs or school bonds in general, but in order to allow school districts the flexibility to finance badly needed school facilities at a time when state support is lacking, let's hope the pendulum doesn't swing too far.

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