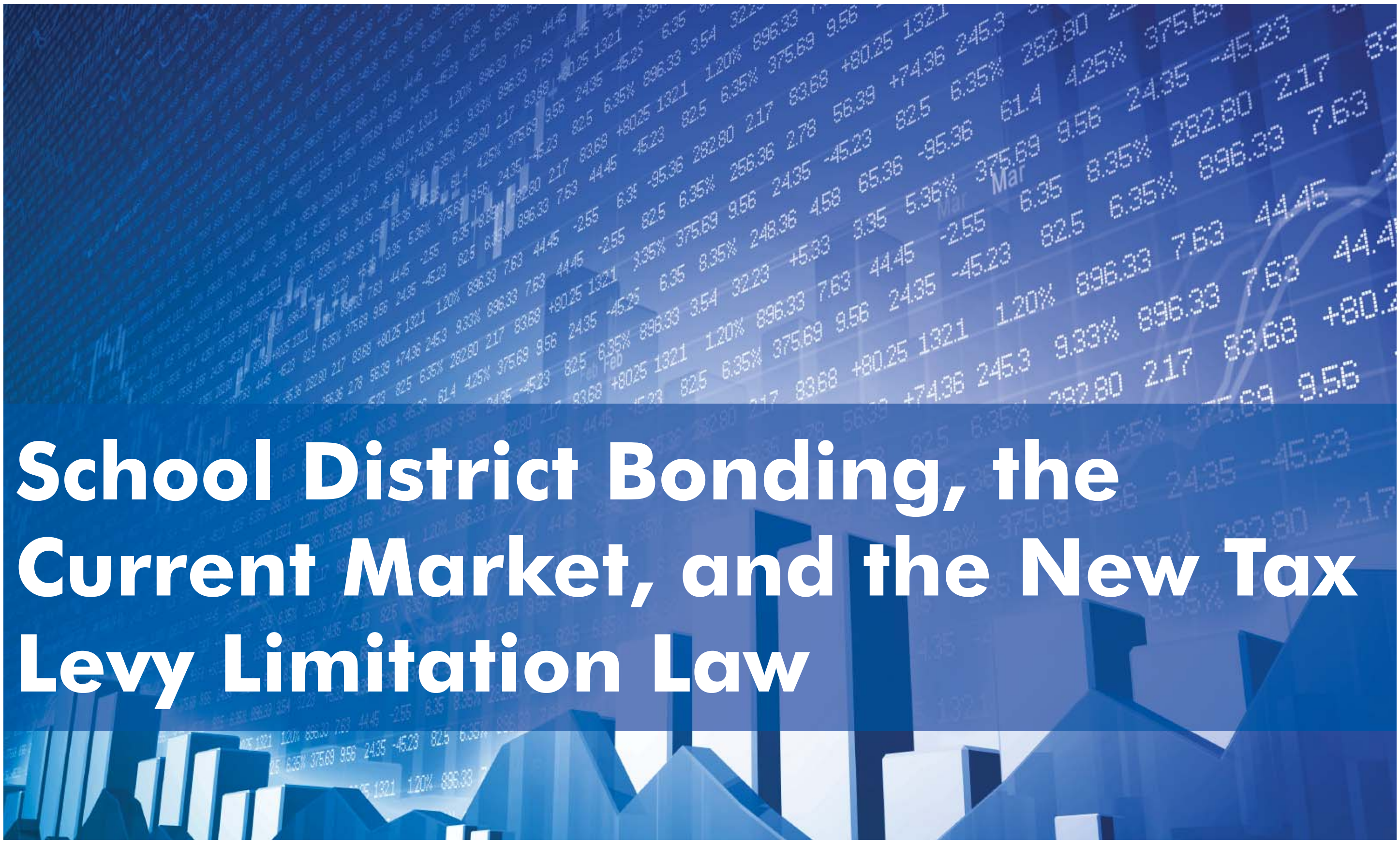

School District Bonding, the Current Market, and the New Tax Levy Limitation Law

by Douglas E. Goodfriend, Esq.

On June 24, 2011, Chapter 97 of the Laws of 2011 was signed into law by the Governor (the "Tax Levy Limitation Law" or "Chapter 97"). The Tax Levy Limitation Law applies to all school districts with the exception of the Big 5 City School Districts (Buffalo, Rochester, Syracuse, Yonkers and New York City as to which the impact occurs through the tax cap applicable to the city itself.)

Since the enactment of Chapter 97, establishing a tax levy limitation regime for school districts and other local governmental units in New York State, school district business officials and others in the municipal finance business of authorizing and issuing debt have wondered what effect the new tax cap might have on interest rates for newly issued school district notes and bonds. The answer thus far, to put it succinctly, has been, none whatsoever. Why is that? There are four basic reasons: (1) the nature of the obligations which school districts issue, (2) the limited impact the tax cap has on typical school district debt, (3) the State Aid intercept and (4) broader national and global trends and concerns. Let us look first at the Constitutional context that determines the nature of the obligations and how Chapter 97 treats debt service, including some minor Constitutional issues raised by Chapter 97 and, why from the market point of view, the tax cap is not yet a significant concern. Then we will look briefly at the State Aid intercept and broader factors affecting the market for school district debt.

The Debt Service Exception

There is an exception for school districts to the tax levy limitation provided in the Chapter 97 for "Capital Local Expenditures" subject to voter approval where required by law. This term is defined in a manner that does not include certain purposes for which a school district may issue debt including the payment of judgments or settled claims including those for torts and tax certiorari payments, and cashflow borrowings including tax anticipation notes, revenue anticipation notes, budget notes and deficiency notes. "Capital Local Expenditures" are defined as "the taxes associated with budgeted expenditures resulting from the financing, refinancing, acquisition, design, construction, reconstruction, rehabilitation, improvement, furnishing and equipping of or otherwise providing for school district capital facilities or school district capital equipment, including debt service and lease expenditures, and transportation capital debt service, subject to the approval of the qualified voters where required by law". The portion of the tax levy necessary to support "Capital Local Expenditures" is defined as the "Capital Tax Levy", and this is an exclusion from the annual tax levy limitation.

The "Capital Tax Levy" exclusion is itself helpful to marketing of school district capital project notes and bonds because that debt is then backed by the authority to raise taxes without limitation on that amount for that purpose, just as it always has been. However, the State Constitution provides the essential support for the market for school district debt.

To understand the protections that the State Constitution provides to holders of school district debt and minor issues that might arise under Chapter 97 for non-capital debt, let's look at the Constitutional framewok.

The Constitutional Context

Article 8 Section 2 of the State Constitution requires every issuer of general obligation notes and bonds in the State to pledge its faith and credit for the payment of the principal thereof and the interest thereon. This has been interpreted by the Court of Appeals, the State's highest court, in Flushing National Bank v. Municipal Assistance Corporation for the City of New York, 40 N.Y.2d 731 (1976), to be "both a commitment to pay and a commitment of the city's revenue generating powers to produce the funds to pay. That is why both words, "faith" and "credit", are used and they are not tautological."

The pledge has historically been understood as a promise to levy property taxes without limitation as to rate or amount to the extent necessary to cover debt service.

Article 8 Section 2 of the Constitution also specifically provides: "If at any time the respective appropriating authorities shall fail to make such appropriations, a sufficient sum shall be set apart from the first revenues thereafter received and shall be applied to such purposes. The fiscal officer of any county, city, town, village or school district may be required to set apart and apply such revenues as aforesaid at the suit of any holder of obligations issued for any such indebtedness."

Article 8 Section 10 of the Constitution provides a limitation on the amount of taxes that may be levied by a county, city, village or school district and an exception to that limitation. This Constitutional tax levy limitation does not apply to any school districts at this time because no limitation percent is provided! This provision expressly states that "the amount to be raised by tax on real estate in any fiscal year *in addition to providing for the interest on and the principal of all indebtedness* shall not exceed an amount equal to the following percentages of the average full valuation" and it goes on to provide such percentages for other types of local government. (Italics added). While this provision does not apply for school districts, it is nonetheless instructive of the structure of the Constitutional approach to tax levy limitations vis-à-vis debt service.

In addition, Article 8 Section 10 does state that it shall not be deemed to restrict the powers granted to the State Legislature by other provisions of the Constitution to further restrict the powers of any county, city, town, village or school district to levy real estate taxes. This ties the limitation and exception into the other Constitutional

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provisions discussed herein, indicating the intent to treat them in an integrated manner. And that does include Article 8 Section 12 discussed below which permits legislative levy restrictions. However, no provision of the Constitution grants powers to the State Legislature to convert a Constitutional exception to a real property tax limitation into a further limitation.

<u>What is important to note here is this:</u> The levy for debt service is separate from the general tax levy limitation in this Constitutional provision. There are two boxes conceptually:

Constitutional Model (Two Boxes)

The Tax Levy (Other Than Debt Service)	The Tax Levy For Debt Service

Article 8 Section 12 of the State Constitution specifically provides as follows:

> "It shall be the duty of the legislature, *subject to the provisions of this constitution,* to restrict the power of taxation, assessment, borrowing money, contracting indebtedness, and loaning the credit of counties, cities, towns and villages, so as to prevent abuses in taxation and assessments and in contracting of indebtedness by them. Nothing in this article shall be construed to prevent the legislature from further restricting the powers herein specified of any county, city, town, village or school district to contract indebtedness or to levy taxes on real estate. The legislature shall not, however, restrict the power to levy taxes on real estate for the payment of interest on or principal of indebtedness theretofore contracted." (Italics Added).

Note: Again, the levy for debt service "theretofore contracted" (i.e. outstanding prior to any new state legislative limitation law) is conceptually <u>separate from</u> the general tax levy.

On the relationship of the Article 8 Section 2 requirement to pledge the faith and credit and the Article 8 Section 12 protection of the levy of real property taxes to pay debt service on outstanding bonds subject to the general obligation pledge, the Court of Appeals in the <u>Flushing National Bank</u> case stated:

> "So, too, although the Legislature is given the duty to restrict municipalities in order to prevent abuses in taxation, assessment, and in contracting of indebtedness, it may not constrict the city's power to levy taxes on real estate for the payment of interest on or principal of indebtedness previously contracted….While phrased in permissive language, these provisions, when read together with the requirement of the pledge of faith and credit, express a Constitutional imperative: debt obligations must be paid, even if tax limits be exceeded".

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In addition, the Court of Appeals in the Flushing National Bank case has held that the payment of debt service on outstanding general obligation bonds and notes takes precedence over fiscal emergencies and the police power of municipal corporations.

Practical Considerations

Why does this matter in a school district?

Firstly, the Constitutional protections provided to holders of school district debt are of great importance to buyers.

Secondly, the "Capital Tax Levy" exception in Chapter 97 provides school districts, in comparison to all other local governmental units, with the benefit of the "two box" approach of the Constitutional provisions with regard to building projects and transport vehicles. The constitutional pledge of faith and credit remains unrestricted as to the levy to pay debt service for these purposes.

However, it must be remembered that the "Capital Tax Levy" does not cover all items for which a school district borrows and, in the event of a defeated tax levy vote, Chapter 97 is not clear as to the treatment of the "Capital Tax Levy". In those cases, it may no longer be possible to pledge to levy property taxes without limitation as to rate or amount to cover debt service but rather, such debt may carry a pledge to levy taxes subject to the new applicable limitations on the levy.

Chapter 97 thus appears to raise Constitutional issues in two regards for school districts:

1. Debt for purposes that are not included in the definition of "Capital Local Expenditures" does not have benefit of the "Capital Tax Levy" exclusion. To be fair, the State Legislature arguably has the Constitutional authority to limit the exclusions for debt contracted after June 24, 2011, the date Chapter 97 became law (although a strong argument can certainly be made that the intent of the integrated Constitutional provisions was to treat all debt service with the pledge of the faith and credit as separate) but arguably not before. Debt service on bonds or notes to finance judgments or settled claims or to pay tax certioraries, or on notes to cover a cash flow problem will not be an exclusion from the 2012-2013 tax levy limitation. Even if issued prior to June 24, 2011, the effective date of Chapter 97, in which case it should be treated as debt "theretofore contracted", but it isn't. Perhaps the State Legislature could be persuaded to amend Chapter 97.
2. If the tax levy is defeated and a district does not go for a second vote, or if the second vote is likewise defeated, Chapter 97 provides, simply, that the tax levy for the new fiscal year may not exceed the tax levy for the prior fiscal year. That raises a significant question.

Without the new annual calculation of exceptions, adjustments and exclusions? It is not clear! On its face, the language of the act does not include any exceptions, adjustments or exclusions. If not, the "Capital Tax Levy" is no longer a separate box for the new fiscal year. In the contingent budget for the new year, there may be only one box. And thus a Constitutional issue becomes pertinent, for

Chapter 97 Model: One Tax Levy In Certain Cases (One Box)

Debt Service
Pensions
Health Care Costs
Mandates
Other School Operations

in that constrained contingent budget every dollar spent for debt service on a new "Capital Local Expenditure" (including any increased debt service for outstanding bond issues) would now not be available for district operations and debt "theretofore contracted" as protected by the Constitution would not thus be excluded. (Any portion of the prior year's tax levy that was for "Capital Local Expenditures" would, in effect, remain by virtue of the fact that the dollar amount of the prior levy is the dollar amount of the new levy so it is, in effect, built in).

To the extent that a district utilizes a substantially level or declining amortization structure for its outstanding debt, and does not add any new otherwise excluded debt, no problem will arise. However, debt amortizing on the

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traditional "50%" rule basis may include increased debt service and new debt will involve increases regardless how it amortizes. A careful analysis of a district's debt profile is thus essential.

Hopefully, the ambiguity in Chapter 97 as to the "Capital Tax Levy" exclusion (and the other exclusions) in a contingent budget will be favorably resolved by interpretation of the concerned agencies in Albany, or by the State Legislature fixing this glitch, sooner rather than later.

In any event, the argument in favor of the Constitutionality of Chapter 97, even in a contingent budget context, is that limiting a tax levy which includes debt service would not unconstitutionally impinge on the ability of a school district to raise taxes to pay debt service.

Why? Because proponents of Chapter 97 argue that the school district can either cut expenses other than debt service to the extent necessary or override the limit. Two points are important here.

1. The drafters of the Constitution by virtue of the two box conceptual structure of the relevant provisions, specifically established a framework to avoid an end game of payment of school operations vs. debt service; and
2. Every dollar in debt service in a one box view deprives the school district of that same dollar for school operations absent special action to override the tax cap not envisioned in the Constitution.

The separate "Capital Tax Levy" in Chapter 97 respects the Constitutional separation for regularly approved levies for most capital purposes. Whether the Constitution grants a school district authority to treat debt service payments as a Constitutional exception to any such tax levy limitation outside of any statutorily determined tax levy amount in the contingent budget context, or for previously outstanding debt for non-capital purposes, is not clear.

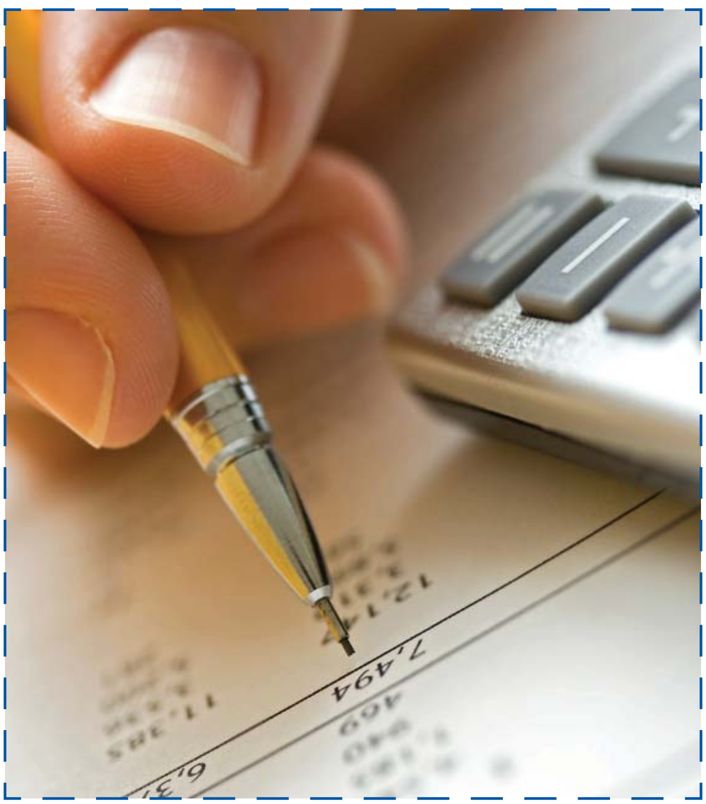
TANs and RANs

The impact of the tax levy limitation on debt service payable on tax anticipation notes ("TANs") and revenue anticipation note ("RANs") despite their not being part of the "Capital Tax Levy" exception is ultimately insignificant. Why?

1. TANs are issued in anticipation of those real property taxes that are in the budget and levy which will be used to pay off the TANs; and
2. RANs are generally issued in anticipation of state aid that is in the budget as revenue, and will be available to pay off the RANs, although the faith and credit pledge which includes the tax levy revenues also applies.

A school district can only borrow on a TAN in anticipation of what has been or will be levied. (Chapter 97 imposes no restriction on the issuance of TANs for actually levied or to be levied real property taxes). If a TAN matures in the same fiscal year as it was issued (or the next fiscal year when issued in the 10 day window before for the new fiscal year) then the taxes which will pay off the principal are simply those in the general tax levy. (No capital levy is involved). And if that TAN should mature in the next fiscal year, then, as described below, the principal will still be payable from the prior fiscal year's taxes. (But even if it were paid from the new fiscal year's taxes, the amount of the prior year tax levy without any deduction for a TAN borrowing is the base of the new year's levy). Therefore, the lack of an exclusion from the tax levy is not relevant in the case of TANs, except as to interest.

The situation with RANs is somewhat similar, though without the self-reflective element of borrowing against taxes in a tax levy context. With RANs, a school district is usually borrowing against State aid that it is already anticipates receiving during the fiscal year in which it is borrowed. (It may also borrow two weeks before that fiscal year but only for new fiscal year expenses.) So, if the RAN matures in that fiscal year, and the aid comes in as anticipated, the borrowing is neutral as to the tax levy, except as to the interest payable. If the aid is not received in that year, then, of course, a RAN can be renewed for a year (up to the close of the second fiscal year succeeding the fiscal year in which the RAN was issued) and paid off when the aid is received. If the maturity date is initially in the succeeding fiscal year, then aid monies from the prior year are to be used, as described below, to pay off the principal. So the lack of an exclusion from the tax levy is again not relevant, except as to interest.



The point here is that it should not take any additional levy to pay off principal of a TAN or RAN.

Significantly, the principal amounts of these cashflow obligations are protected by specific Local Finance Law rules that require a school district to set aside in a separate account the last-in receipts of these revenues if borrowed against in order to ensure this repayment (unless otherwise provided for). Thus only the budgetary appropriation for interest is at risk in any event to the TAN or RAN note holder (unlike a bond anticipation note or a serial bond which do not have statutory set asides and may not have revenue sources other than the tax levy to pay down full principal due in the first instance; however, most BANs and bonds will benefit from the "Capital Tax Levy" raised on their behalf).

The State Aid Intercept

Finally, consider Section 99-b of the State Finance Law which provides that in the event of a default in the payment of the principal of and/or interest on any bond or note issued by a school district, it is the duty of the State Comptroller to immediately investigate, make a written certificate of determinations with respect thereto and serve a copy thereof upon the chief fiscal officer of the school district which issued the bond or note. Such investigation by the State Comptroller must review the current payment on **all** outstanding bonds and notes of that school district and must set forth a description of all such bonds and notes of the school district found to be in default and the amount of principal and interest past due.

Section 99-b then requires that office to thereafter deduct and withhold from the next succeeding allotment, apportionment or payment of such State aid or assistance due to such school district such amount thereof as may be required to pay (a) the school district's contribution to the State teachers retirement system, and (b) the principal of and interest on such bonds notes of such school district

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then in default and to forward such intercepted State aid monies promptly to the paying agent or agents for the bonds and notes in default of such school district for the sole purpose of the payment of defaulted principal of and interest on such bonds or notes.

This requirement constitutes a covenant between the State and the purchasers and the holders and owners from time to time of **all** general obligation bonds and notes issued by the school districts in the State that cannot be repealed, revoked or rescinded by the State. School district debt holders are thus all well-protected by this provision, in addition to the Constitutional ones, as long as there is State aid to school districts.

Impact on Bond Market of Chapter 97

Thus far, Chapter 97 has not resulted in any discernible interest rate increases for school district debt. Why is that?

First, all school district debt (Bonds, BANs, TANs, RANs) benefits from the Constitutional protections provided to holders of all such debt through the mandatory pledge of the faith and credit, and the statutory protection of Section 99-b.

Second, it is clear that Chapter 97 affects the tax levy but not for most debt service. For most capital debt, it remains true that a school debt can levy a tax without limitation as to rate or amount to pay that debt service. Although TANs and RANs are not covered by the Capital Tax Levy exclusion, the market has not distinguished its treatment of bonds and BANs for capital projects and TANs and RANs for cashflow purposes, because all are subject to general Constitutional protections and the provisions of Section 99-b.

Third, it is clear that no statute is able (1) to limit a school district's pledge of its faith and credit to the payment of <u>any</u> of its general obligation indebtedness or (2) to limit a school district's levy of real property taxes to pay debt service on general obligation debt contracted prior to the effective date of Chapter 97.

Fourth, since debt service on obligations issued for capital projects and buses and other transport are excluded and school districts also receive varying amounts of state aid for them, that leaves for most school districts only debt service on the interest payments for TANs and RANs not covered by the "Capital Tax Levy" exclusion and that has a relatively small impact on the levy amount.

Fifth, no school district has defaulted on the timely payment of principal of or interest on its indebtedness in living memory in the State.

Certainly over time, the tax cap may raise broader credit concerns over matters of fiscal management and of board decision making within its constraints. For now, the tax cap

is too new to predict the problems that it will cause, the resolutions that school districts will choose to implement, and the responses of the rating agencies and the buyers of school district debt.

So, what else may have an impact on the market for school district debt?

Current Market for School District Debt

The current market for tax-exempt debt issued by school districts in New York State can be succinctly characterized as follows: Historically low interest rates for significantly reduced volume. Will this continue? There are several broader factors which are likely to have an impact on the interest rates school districts pay on debt issued in the coming year:

- The European sovereign debt crisis and its resolution. The crisis in Greece, Spain, Portugal, Italy and Ireland has raised the general level of concern about governmental debt of any type.
- The attendant banking liquidity and solvency issues for some banks holding "peripheral European" debt. This could have a definite destabilizing effect on the international financial situation. A liquidity crisis could affect all financial markets including municipals.
- The Standard & Poor's downgrade of U.S. sovereign debt. A shock to the governmental debt markets yet no discernible impact on rates, because the dollar remains the "refuge currency" and the European crisis has only reinforced that and propped up Treasury prices, keeping yields down.
- Outlandish claims of extensive defaults and bankruptcies of municipalities by certain financial commentators having been proven to be a "Henny Penny". Nevertheless, there are ongoing concerns about municipalities and school districts and now they will handle pension and healthcare costs and revenue pressures.
- The Select Deficit Reduction Commission and their proposals. Might they include restrictions on the federal tax exclusion for interest on school district and other local government debt?
- The American Jobs Bill of 2011: Includes a proposal to limit the federal income tax exclusion for tax-exempt interest to 28% rather than the current 100% exclusion. If adopted there is some likelihood it would exert upward pressure on municipal bond interest rates.
- The very low interest rates market is resulting in some retail buyer resistance to the rates on offer. When a bond anticipation note is yielding under 1.00%, why bother? Still, trust and other managed accounts, insurance companies and money market and some mutual funds are buying.
- The low interest rate market has created an appetite for "premium bonds". If the market rate for a five-year bond is 2.50%, buyers now prefer to pay more than $5,000 for a bond with a face (par) amount of $5,000 and in return get a higher rate, say 3.00%. That premium over $5,000 is paid to the issuer to make up for the fact that they have to pay 3.00% for 5 years when the market is 2.50%. The ultimate interest expense to the borrower is close to identical (but there are inefficiencies in callable bonds) and such bonds sell better in a market where the only place for rates to go, over time, is most likely, eventually up. Why? Because the buyer has a bond in hand with a stated interest rate that may be where the actual market is, in time. This is easier to sell if need be at that time.
- The current low market supply may change and if volume picks up (especially due to refundings), that will test the market at its current interest rate levels, possibly increasing yields.
- Concern about liquidity in the municipal debt market. (If I buy it, can I sell it?)

Whether this confluence of factors will result in rising interest rates is simply not knowable. If you do know, please call me.

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